(1)

No. ___

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

SUSAN MORAN, *et al.*,
Petitioners,

v.

J. ELLIOTT HIBBS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Arizona

---

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether state taxation of the mandatory retirement plan contributions of federal civilian employees violates 4 U.S.C. § 111 (2000) when the mandatory retirement plan contributions of identically-situated state and local government employees are exempt from state tax.

PARTIES TO THE PROCEEDING

The parties to the consolidated proceedings below were the taxpayer plaintiffs, Clark J. Kerr, his wife, Billie Sue Kerr, Susan Moran, Steve Allen and John Udall. The action was brought as a class action on behalf of each of the taxpayer plaintiffs and the approximately 42,000 similarly circumstanced federal employees in the State of Arizona. The defendants included Mark J. Killian in his official capacity as the Director of the Department of Revenue and the Arizona Department of Revenue. The Department of Revenue also appeared as a plaintiff with respect to its claim concerning the tax year 1984. The taxpayer plaintiffs and the law firms of Bonn, Luscher, Padden & Wilkins, Chartered, its successor in interest, Bonn & Wilkins, Chartered, and O'Neil, Cannon & Hollman, S.C. maintained counterclaims against the Department of Revenue regarding attorney fees. Mr. Kerr did not work for the federal government after 1990 and therefore, he and his wife are not petitioners here. Petitioners Susan Moran, Steve Allen and John Udall continued as federal employees for years after 1990. Mark J. Killian has been succeeded as Director of the Arizona Department of Revenue by J. Elliott Hibbs, who is thus named as a respondent in his official capacity as Director of the Arizona Department of Revenue.

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PETITION FOR WRIT OF CERTIORARI

Susan Moran, Steve Allen and John Udall, on behalf of themselves and all others similarly situated, respectfully petition this Court for a writ of certiorari to the Supreme Court of Arizona.

OPINIONS BELOW

The opinion of the Supreme Court of Arizona is reported at 84 P.3d 446 (2004). App 1a–22a. The amended decision of the Arizona Court of Appeals is reported at 65 P.3d 434 (Ariz. Ct. App. 2001). App. 23a–49a. The initial decision of the Arizona Court of Appeals in this case is reported at 32 P.3d 408 (Ariz. Ct. App. 2001). App. 50a–69a. The Judgment of the Arizona Superior Court on the parties' cross motions for summary judgment is unreported. App. 70a–73a. For the sake of completeness, prior opinions of the Arizona Court of Appeals, which provide additional historical background of this controversy and litigation, are reported at

3 P.3d 1133 (Ariz. Ct. App. 2000), App. 74a–87a; 916 P.2d 1173 (Ariz. Ct. App. 1996), App. 88a–106a; and 899 P.2d 162 (Ariz. Ct. App. 1994). App. 107a–153a.

JURISDICTION

The opinion of the Supreme Court of Arizona was entered on February 13, 2004. This petition is, accordingly, filed within the time allowed by law. Jurisdiction to review the decision in this case by writ of certiorari is conferred upon this Court by 28 U.S.C. § 1257(a) (2000).

STATUTORY PROVISIONS INVOLVED

Title 4, United States Code, section 111 provides, in relevant part:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

Title 26, United States Code, section 414(h) provides, in relevant part:

> Tax treatment of certain contributions.—
>
> (1) In general.—Effective with respect to taxable years beginning after December 31, 1973, for purposes of this title, any amount contributed—
>
> (A) to an employees' trust described in section 401(a), or
>
> (B) under a plan described in section 403(a), shall not be treated as having been made by the employer if it is designated as an employee contribution.
>
> (2) Designation by units of government.—For purposes of paragraph (1), in the case of any plan established by the government of any State or political subdivision

> thereof, or by any agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Pertinent provisions of the relevant state statutes are set forth at App. 157a–163a.

STATEMENT OF THE CASE

This litigation arose in the wake of this Court's decision in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). In *Davis*, this Court invalidated Michigan's taxing scheme that discriminated in favor of local and state government retirees and against federal retirees. *Id.* at 817. This case, like *Davis*, involves a taxing scheme shared by over 20 states that affects over a million federal employees. But unlike *Davis*, this case involves discriminatory state taxation of the *current* compensation of federal employees.

Arizona, like most governmental employers, offers contributory pension plans for its employees. In order for state and local pensions plans to be "qualifying" under the Internal Revenue Code, they must include both employer and mandatory employee contributions. Thus, like the federal pension plans, Arizona's plans include both employer and mandatory employee contributions. Unlike the federal plans, however, Arizona is authorized under the Internal Revenue Code, and has opted, to pick up the payment of the employees' mandatory contribution. For federal income tax purposes only, the mandatory contribution "picked up" by the state is excluded from federal adjusted gross income.

In addition to picking up employees' mandatory contributions, since as far back as 1943 Arizona has also exempted this portion of state employees' compensation from state income tax. This exemption applies currently to *all* state

and local employees in the State of Arizona.[1] Arizona does not provide a similar exemption for federal employees. Thus, Arizona state and local employees pay no state income tax on the portion of their compensation representing the employee mandatory contribution to their pension plan while federal employees pay income tax to the State of Arizona on that identical portion of their current compensation. Under Arizona's tax scheme, for example, a hypothetical federal employee who earned $100,000 and who made a seven per cent retirement contribution would pay state income tax on the full $100,000 salary; an identically situated state employee would pay state income tax only on $93,000 of his $100,000 salary.

This discriminatory treatment arises out of two independent statutory bases. First, the exemption from income tax for current state and local employees is contained in the statutory provisions of the various state retirement plans themselves. Just as Arizona formerly provided a statutory exemption for the pensions of state and local employees, it currently provides in the various pension statutes exemption from taxation for the mandatory employee contribution. *See* App. 7a n.6 ("In addition to the subtractions from income previously set forth [in the state tax code] for contributions to state retirement plans, the statutes governing [the state retirement plans] have long provided that member contributions 'are exempt from state, county and municipal taxes.'") (citation omitted). *See also* Ariz. Rev. Stat. § 38-

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[1] Between 1991 and 1999, new hires in two small retirement plans were not provided this exemption. During this same period, well over 180,000 state and local government employees were exempt from the tax. Until 1990, Arizona also provided an express subtraction in its income tax code for State employees' mandatory contributions. However, the State confessed judgment as to those years, acknowledging that Arizona's discriminatory scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine because of the express subtraction.

792 (2004) ("The member and employer contributions . . . are exempt from state, county and municipal income taxes.") App. 160a.

The second source of the exemption for state and local government employees is Arizona's adoption of the federal adjusted gross income from the Internal Revenue Code as the starting point for determining Arizona gross income. *See* Ariz. Rev. Stat. § 43-1001(2) (2004) ("'Arizona gross income' of a resident individual means the individual's federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code.").[2] Under 26 U.S.C. § 414(h), employee retirement contributions of state and local governments "picked up" by the employer are excluded from federal adjusted gross income. Accordingly, in Arizona (and many other states), that portion of state and local employees' compensation representing their mandatory retirement contribution is excluded from federal adjusted gross income, and thereby escapes state taxation. There is no Arizona income tax subtraction that permits federal employees to subtract their mandatory contributions from Arizona gross income, nor is there a provision that requires State employees to add their mandatory contributions back in to equalize the treatment of the two groups.

Thus, this case arises in this Court on the undisputed record that Arizona taxes the current compensation of all federal employees representing their mandatory contributions to federal retirement systems, while exempting from taxation the identical element of compensation of its own employees. Not only is this discrimination uncontroverted, but so too it is conceded that the mandatory contributions of state and local

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[2] The Arizona legislature also provides numerous subtractions and additions to determine Arizona gross income, including, for example, subtractions for interest from federal obligations and Railroad Retirement Benefits. *See, e.g.*, Ariz. Rev. Stat. §§ 43-1021 and 43-1022 (2004).

government employees are substantively indistinguishable from the mandatory contributions of federal employees and that 26 U.S.C. § 414(h) does not affect what is compensation.[3]

After years of procedural skirmishes, in 2000 the taxpayers were finally able to obtain a ruling on the merits of their claim. The trial court sustained their challenge, held that Arizona's discriminatory taxation scheme violated 4 U.S.C. § 111 and the doctrine of intergovernmental tax immunity, and ordered the State to pay refunds. App. 72a. Ultimately, the Arizona Court of Appeals affirmed the trial court. App. 24a. Yet the Arizona Supreme Court, on the State's jurisdictionally untimely petition for review,[4] reversed the lower courts. Despite the overwhelming evidence and admissions by the State to the contrary, the Supreme Court of Arizona concluded that Arizona's discriminatory income tax scheme does not discriminate against federal employees because of the source of their compensation. App. 2a. The Arizona Supreme Court reasoned that the only impediment to federal employees receiving the same tax treatment as State employees was Congress's failure to "pick-up" federal employees' mandatory contributions. The court concluded that when and if Congress changes federal law, Arizona will then treat federal employees equally. App. 19a.

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[3] For example, the State conceded below that the mandatory contributions are part of a state or local government employee's compensation, including for purposes of retirement benefits calculations, workmen's compensation, vacation pay, sick pay, unemployment insurance and social security benefits. *See* Petitioners' Cross-Motion for Summary Judgment.

[4] Arizona law provides that a party must seek review within 15 days of the mailing of a determination on reconsideration. *See* Ariz. R. Civ. App. P. 23(a) (2004). *See also In re Estate of Alarcon*, 718 P.2d 989 (Ariz. 1986). The State's petition was due by March 17, 2003 but it was not filed until March 31, 2003. The Supreme Court of Arizona denied the taxpayers' motion to dismiss the State's petition without comment.

Because the Arizona Supreme Court's decision is fundamentally flawed, and because its decision validates a discriminatory taxation scheme prevalent throughout the Untied States, the taxpayers bring this petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

This case presents questions of substantial public importance concerning the practice of Arizona, and twenty-eight other states, of discriminatorily taxing the mandatory retirement contributions of federal employees' current compensation. In *Davis v. Michigan*, 489 U.S. 803, 817 (1989), this Court held that states could not tax the annuities of retired federal employees if they exempted the annuities of state and local government employees from state taxation. This case is essentially indistinguishable from *Davis*, with the exceptions that here the discrimination affects the *current* compensation of federal employees, not their pensions, and, because the discriminatory practices are more pervasive among the states, the discrimination affects more federal employees.

With its decision below, the Supreme Court of Arizona has flouted this Court's holdings in *Davis v. Michigan*, and *Barker v. Kansas*, 503 U.S. 594 (1992), among others. So too, in holding that it is Congress's burden to cure the discrimination by altering its compensation schemes for federal employees, the court below has turned the doctrine of intergovernmental tax immunity on its head. Review by this Court is necessary to bring Arizona law into conformity with the decisions of this Court and to end its practice of discriminating against the United States and those with whom it deals.

1. In *Davis v. Michigan*, this Court invalidated Michigan's discriminatory taxation of federal retirement benefits. At the

time the Court decided *Davis*, 23 states gave preferential tax treatment to benefits received by state and local government retirees relative to the tax treatment received by federal employees. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 93 (1993).

Arizona's challenged tax, in contrast to *Davis*, affects the *current* compensation of some forty-plus thousand federal employees.[5] But, as in *Davis*, Arizona's discriminatory tax scheme is not unique. Indeed, far from it—it appears that there are at least 28 additional states that have adopted tax schemes similar to Arizona's that discriminate against federal employees by providing an exemption for the mandatory retirement contributions of state and local government employees. App. 167a–169a. Thus, this case implicates the interests of over a million current federal employees across the nation.

Some states that, like Arizona, have adopted the federal Adjusted Gross Income as the starting point for determining state tax liability, have nonetheless corrected for this discrimination.[6] Maryland, for example, specifically requires state employees to add to their Maryland adjusted gross income amounts "excluded from federal adjusted gross income under [26 U.S.C.] § 414(h)(2)." Md. Code Ann., Tax-Gen. § 10-204(f)(2) (2003). Virginia, in contrast, makes no such correction—indeed, its Tax Commissioner has specifically ruled that it need not do so. *See* Re: § 58.1-1821 Application: Indiv. Income Tax, P.D. 94-354, 1994 Westlaw 722715 (Va. Dep't Tax. Nov. 23, 1994). California, which

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[5] State-by-state federal employment statistics as of December 31, 2000 are available at http://opm.gov/feddata/geograph/table3.pdf (visited Apr. 27, 2004).

[6] *See, e.g.*, Mass. Gen. Laws Ann. ch. 62, § 2(a)(1)(1) and ch. 32 § 22(10) (2004); N.Y. Tax Law § 612(b) (26) (Consol. 2004); Kan. Stat. Ann. § 79-32, 117(b)(vi) (2003); Me. Rev. Stat. Ann. tit. 36, § 5122(G) (West 2003); Md. Code Ann., Tax-Gen. § 10-204(f)(1) and (2) (2003).

has the highest number of federal employees (nearly a quarter million), joins Virginia and Arizona in discriminatorily taxing federal employees.

This widespread difference in treatment among the states impacts over a million federal employees nationwide. So too, it directly implicates the interests of the United States—as this Court recognized in *Davis*, "[t]axes enacted to reduce the State's employment costs at the expense of the federal treasury are the type of discriminatory legislation that the doctrine of intergovernmental tax immunity is intended to bar." 489 U.S. at 815 n.4. Review by this Court is necessary not only to resolve this issue of inconsistent application from state to state but also to ensure that the United States is not involuntarily subsidizing the employment costs of state governments.

2. The court below held that Arizona's discrimination was not based on the source of federal employees' income; rather, it held, the discrimination was based on Congress's allowing states to "pick up" employee contributions and its decision not to "pick up" the contributions of federal employees. App. 18a. Thus, the court held, Congress was free to cure the discrimination simply by changing the way in which it compensates federal employees: "When and if the federal employer makes the same choice [to pick up the employee contribution], Arizona tax law will treat its employees' contributions in an identical fashion." App. 19a.

This holding defies the precedent of this Court. Indeed, it turns the doctrine of intergovernmental tax immunity on its head—it is the states' responsibility, not Congress's, to ensure that they do not discriminate against the United States or those with whom it deals. Review by this Court is necessary to ensure that this perversion of the law of intergovernmental tax immunity, which has already been adopted by at least one other state, does not gain currency.

As this Court has held "from the time of *McCulloch v. Maryland*,"[7] the intergovernmental tax immunity doctrine "barred taxes that 'operat[e] so as to discriminate against the Government or those with whom it deals.'" *Davis v. Michigan*, 489 U.S. at 812 (quoting *United States v. City of Detroit*, 355 U.S. 466, 473 (1958)). While this doctrine has now been codified in 4 U.S.C. § 111, the prohibition against discriminatory state taxation has been, and continues to be, a constitutional imperative. Moreover, in all of this Court's jurisprudence, the doctrine has always been characterized as one of *immunity* from state taxation. As such, it is not a matter subject to states' control or conditions. Rather, this is an area "over which Congress is the principal superintendent." *Jefferson County v. Acker*, 527 U.S. 423, 437 (1999).

Indeed,

> the federal tax immunity has always been greater than the States' immunity. The Federal Government, for example, possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity. *See, e.g., Graves v. People of State of New York, ex rel O'Keefe*, 306 U.S. 466, 478 (1939). The States lack any such power.

South Carolina v. Baker, 485 U.S. 505, 520 n. 11 (1988). As a corollary to this greater immunity, the United States has always been free to discriminate in matters of taxation against itself and those with whom it deals. For example, the federal government has taxed income from federal bonds while not taxing income from state bonds, but that fact gives the States no power to discriminate. *Id.* Arizona recognizes this limitation on its taxing power by its subtraction for interest

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[7] 17 U.S. (4 Wheat.) 316 (1819).

received from federal obligations. *See* Ariz. Rev. Stat. § 43-1022 (2004).[8]

The court below suggests that Arizona will cease discriminating against federal employees when Congress changes its compensation schemes for federal employees. App. 19a. So too, the Virginia Tax Commissioner has opined that Virginia will stop discriminating when "Congress decides to offer" a pension plan similar to Virginia's. P.D. 94-354, 1994 Westlaw 722715, at 2. But it is not Congress's burden to structure compensation for federal employees in such a way that it mirrors how any particular state has chosen to compensate its employees. Rather, it is the states' *privilege* to impose an income tax on federal employees, but only to the extent that they do so in a non-discriminatory fashion.

The decision of the court below, mirrored by Virginia, threatens to erode the government's immunity to the point of meaninglessness. Congress cannot possibly structure the compensation of federal employees in such a way that it is identical to that chosen by all 50 states and countless other governmental entities. Nor, of course, should it be required to do so as a condition of obtaining equal tax treatment for federal employees. Review by this Court is necessary to forestall Arizona's attempt to impose an impermissible burden on the United States and to ensure that it remains the states' burden to structure their tax schemes so that they do not discriminate against the United States or those with whom it deals.

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[8] The federal government in the exercise of its sovereignty has provided a federal tax benefit for federal income tax purposes *only*. *See* G.C.M. 39,540 (Jul. 25, 1986) ("414(h) is only relevant to federal tax treatment and does not bind the state. . . ."). Therefore, there is no basis for the conclusion below that Congress's action may be deemed a ground upon which to claim that it excuses what is plainly discriminatory.

3. The decision below also misinterprets this Court's decision in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). The court below suggests that the intergovernmental tax immunity doctrine applies only to statutes that discriminate on their face against a federal interest. App. 16a. However, that is not the case. This Court has repeatedly admonished courts that in determining whether a tax violates the federal government's constitutional immunity, they "'must look through form and behind labels to substance.'" *Jefferson County v. Acker*, 527 U.S. 423, 439 (1999) (citation omitted). This Court has never constrained the tax immunity doctrine in such a fashion, which would essentially be an open invitation to the states to engage in clever drafting to conceal their discrimination.

Here, the substance of Arizona's proffered rationale fails constitutional muster for precisely the same reason that Tennessee's scheme failed in *Memphis Bank*. 459 U.S. at 398-99. Arizona's scheme operates to discriminate in favor of its employees and against federal employees by including in the tax base *all* income of federal employees while excluding from the tax base an identical element of income of state and local government employees. *See id.* ("The State [discriminates] by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals.") (footnote omitted).[9]

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[9] The decision's suggestion (App. 16a) that Ariz. Rev. Stat. § 43-1001(2) (2004) contains no overt discrimination is untenable. As the record establishes, including the admissions of the State's pension expert, having adopted the federal definition as its tax base, under both a literal reading and a consideration of the tax provision's practical operation, if a taxpayer is not an employee of the state or one of its local subdivisions,

The court below simply glossed over Arizona's independent statutory basis for the discrimination. Under long-standing principles of Arizona law, the statutory provisions of the State's retirement plans are part of an employee's employment contract and are fully vested at the date of employment. *Thurston v. Judges' Ret. Plan*, 876 P.2d 545, 546 (Ariz. 1994); *Yeazell v. Copins*, 402 P.2d 541, 544 (Ariz. 1965).[10] Changes that disadvantage employees can operate only as to future employees. *Yeazell*, 402 P.2d at 546. Thus, every state and local government employee who enjoyed the exemption in 1990 has also enjoyed the exemption throughout the period in issue. App. 157a–163a.

At bottom, the court's failure to address the independent second source of discrimination clearly "suggests that the State's articulated rationale is not in fact the basis for the disparate treatment, but only a cloak for discrimination against federally funded benefits." *Barker v. Kansas*, 503

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the employee cannot qualify for the favored treatment. Stated another way, the favored treatment under Arizona law is based exclusively on the source of an employee's compensation.

[10] Arizona acknowledged this much in its *amici curiae* brief filed in this Court in *Harper v. Virginia Dep't. of Taxation*, 509 U.S. 86 (1993). The Arizona Solicitor General explained the fact that the exemption exists separate and apart from the provisions of the State's tax code:

> [T]he principal North Carolina and Arizona exemptions *were contained in the states' retirement plan statutes, not in their income tax laws. E.g.*, N.C. Gen. Stat. §§ 128-31; 135-9 (1986); former A.R.S. §§ 38-762(A) and 33-781.22(A).
>
> * * *
>
> The tax exemptions for state and local retirees were to all appearances legitimate employment benefits separate and apart from the seemingly wholly legitimate income taxes.

Brief *Amici Curiae* of the States of Arizona and North Carolina in support of *Virginia Department of Taxation*, U.S. No. 91-794, Sept. 8, 1992 at 22 (emphasis added).

U.S. 594, 604-05 (1992) (citation omitted). Review by this Court is necessary to ensure that states may not so easily escape their constitutional obligations when taxing the United States and those with whom it deals.

4. The court below justified Arizona's discriminatory tax by seeking to hide behind the Internal Revenue Code. Specifically, the court held that "nothing in the Arizona scheme discriminates between taxpayers based on the federal or non-federal source of income; instead the distinction is based on whether a particular state employer has voluntarily opted to pick up the employee contribution" as authorized by 26 U.S.C. § 414(h)(2). App. 18a. As noted above, this reasoning is fallacious—the only employees who can benefit under § 414(h)(2) are state and local employees. Thus, Arizona's saying that the discrimination is based on whether the employer "picks up" the contribution under § 414(h)(2) is no more compelling than saying the discrimination is based on whether the employer has the letter "z" in its name. In determining whether a tax violates the federal government's constitutional immunity, courts "must look through form and behind labels to substance." *Jefferson County v. Acker*, 527 U.S. 423, 439 (1999) (citation omitted). This the court below failed to do.

Moreover, as this Court held in *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71, 82 (1992), the "adoption of the federal system in whole or in part, however, cannot shield a state tax statute from [constitutional] scrutiny."[11] The court below eschewed *Kraft*, concluding that because it was a Foreign Commerce Clause case it was too far afield to be instructive in resolving these Supremacy Clause and intergovernmental tax immunity issues. App. 17a n.13. But

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[11] At present count a total of 43 states have adopted the federal system in whole or in part for purposes of either the personal or corporate income tax. App. 164a-166a.

nothing in either the holding or rationale of *Kraft* suggests that it should be so limited.

Accordingly, review by this Court is necessary to make clear that this important principle is not limited to the Commerce Clause. Otherwise, the decision below will provide a road map for States to nullify federal statutory and constitutional protections by invoking the simple expedient that they were merely adopting the Internal Revenue Code. This Court has never before accepted this excuse and it should not do so now.

CONCLUSION

For each of the above reasons, the petition should be granted.

Respectfully submitted,

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April 29, 2004

APPENDIX A

SUPREME COURT OF ARIZONA
EN BANC

No. CV-03-0110-PR

CLARK J. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN and JOHN UDALL, individually and as representatives of the class comprised of federal employees who paid ARIZONA income taxes on FEDERAL RETIREMENT CONTRIBUTIONS during one or more of the years 1984 to date,

Plaintiffs-Appellees,
Cross-Appellants,

v.

MARK J. KILLIAN, in his capacity as DIRECTOR OF THE ARIZONA DEPARTMENT OF REVENUE, THE ARIZONA DEPARTMENT OF REVENUE OF THE STATE OF ARIZONA,

Defendants-Appellants,
Cross-Appellees.

STATE OF ARIZONA *ex rel.*,
THE ARIZONA DEPARTMENT OF REVENUE,

Plaintiff-Appellant,
Cross-Appellee,

v.

CLARK J. KERR and BILLIE SUE KERR, husband and wife,

Defendants-Appellees,
Cross-Appellants.

CLARK J. KERR and BILLIE SUE KERR, husband and wife; and their Attorneys, BONN, LUSCHER, PADDEN & WILKINS, CHARTERED and O'NEIL, CANNON & HOLLMAN, S.C.,
Counterclaimants-Appellees,
Cross-Appellants,

v.

STATE OF ARIZONA *ex rel.*,
THE ARIZONA DEPARTMENT OF REVENUE,
Counterdefendant-Appellant,
Cross-Appellee.

Feb. 13, 2004.

OPINION

HURWITZ, *Justice.*

The question in this case is whether Arizona's income tax scheme violates the intergovernmental tax immunity doctrine because it effectively subjects federal employees' mandatory retirement contributions to current taxation, while deferring taxation of similar contributions by state and local employees. We conclude that the state income tax code does not discriminate against federal employees because of the source of their pay or compensation, and thus does not violate the intergovernmental tax immunity doctrine, codified in 4 U.S.C. § 111(a) (2000).

I.

This case has a long and complicated procedural and substantive history. This litigation commenced in 1989

and has been the subject of five prior reported appellate opinions.[1] We begin with a review of the "long strange trip" [2] that brought this case here.

A. The Federal Tax Code

This controversy has its origins in several arcane provisions of the federal tax code. Under various sections of the Internal Revenue Code, including I.R.C. §§ 401 and 403, governmental employers may choose to establish "contributory" retirement plans. A typical plan requires employees to contribute a portion of their income to the plan (the "employee's contribution") and the employer then contributes additional funds (the "employer's contribution").

In the abstract, both the employee's and employer's contributions would seem to be current taxable income to the employee; the former comes out of the employee's salary, while the latter is plainly a benefit conferred by the employer as a result of the employee's labor. *See generally* I.R.C. § 61 (defining gross income as "all income from whatever source derived"). But, in what has aptly been termed "one example of the dominance of form over substance in the tax code," *Howell v. United States*, 775 F.2d 887, 887 (7th Cir.1985), federal tax law distinguishes between the employee's and the employer's contributions. An employer's contribution to a retirement plan "qualified" under I.R.C. §§ 401(a) and 403(a) is not treated as taxable income for the employee until the plan pays benefits to the employee. *See Howell*, 775 F.2d

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[1] *See Kerr v. Killian*, 204 Ariz. 485, 65 P.3d 434 (App.2003) ("*Kerr V*"); *Kerr v. Killian*, 201 Ariz. 125, 32 P.3d 408 (App.2001) ("*Kerr IV*"); *Kerr v. Killian*, 197 Ariz. 213, 3 P.3d 1133 (App.2000) ("*Kerr III*"); *Kerr v. Waddell*, 185 Ariz. 457, 916 P.2d 1173 (App.1996) ("*Kerr II*"); *Kerr v. Waddell*, 183 Ariz. 1, 899 P.2d 162 (App.1994) ("*Kerr I* "). We refer in this opinion to these previous opinions by the parenthetical short-hands above.

[2] Grateful Dead, *Truckin', on American Beauty* (Warner Bros.1970).

at 887. An employee's contribution to a retirement plan, however, is generally treated as current taxable income to the employee, even if the employee is mandated to make the contributions out of his current pay. *See generally United States v. Basye*, 410 U.S. 441, 449-50, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973) (treating contributions to retirement plan as "anticipatory assignments of income"). The employee is not taxed, however, on the eventual distributions from the plan corresponding to his taxable contributions. *See* I.R.C. § 72.

In 1974, Congress complicated the situation further by enacting Pub.L. No. 93-406, 88 Stat. 825 (1974), codified at I.R.C. § 414(h)(2). Section 414(h)(2) provides that if a state or local governmental employer "picks up" employee contributions to a plan qualified under §§ 401(a) or 403(a), "the contributions so picked up shall be treated as employer contributions," and thus not subjected to current income tax. The Internal Revenue Service has established two criteria that must be met before a state or local government can "pick up" employee contributions:

> First, the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee. Second, the employee must not have the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan.

Rev. Rul. 81-35, 1981-1 C.B. 255.

B. Arizona's Income Tax Scheme

In 1979, Arizona adopted federal adjusted gross income ("AGI") as the starting point for computing Arizona taxable income. 1978 Ariz. Sess. Laws, ch. 213, § 2 (codified as amended at Arizona Revised Statutes ("A.R.S.") § 43-1001(2) (Supp.2003) ("'Arizona gross income' of a

resident individual means the individuals federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code.")). The income tax statutes list a series of items Arizona taxpayers must add to, or may subtract from, federal AGI to reach their Arizona taxable income. *See* A.R.S. § 43-1021 (Supp.2003) (listing twenty-seven additions); *id.* § 43-1022 (listing twenty-nine subtractions).

At the same time that the legislature adopted federal AGI as the starting point for calculating Arizona taxable income, it also amended the state tax code to allow state and local employees to subtract their mandatory retirement contributions from Arizona gross income. 1978 Ariz. Sess. Laws, ch. 213, § 2 (codified at A.R.S. § 43-1022(2) (Supp.1978)). Under the version of § 43-1022(2) adopted in 1978, "[c]ontributions made to the state retirement system, the judges' retirement fund, the public safety personnel retirement system or a county or city retirement plan" could be subtracted from the employee's Arizona gross income.[3] In 1982, the legislature added mandatory contributions to the elected officials' retirement plan ("EORP") to the list of subtractions. 1982 Ariz. Sess. Laws, ch. 126, § 2 (codified at A.R.S. § 43-1022(2) (Supp.1982)). In 1986, contributions to the corrections officer retirement plan ("CORP") were added to the list. 1986 Ariz. Sess. Laws, ch. 325, § 3 (codified at A.R.S. § 43-1022(2) (Supp.1986)).[4]

In addition to allowing subtractions from Arizona taxable income of employee *contributions* to the various retirement plans, Arizona law also provided until 1989 that all *benefits* paid to employees under those plans could likewise be

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[3] We refer in this opinion to the Arizona state retirement system as "ASRS" and the public safety personnel retirement system as "PSPRS."

[4] The same law removed contributions to the judges' retirement fund from the list of permitted subtractions, as that fund had been combined with EORP. *See* A.R.S. § 38-802 (2001).

subtracted. *See* A.R.S. § 43-1022(3) (Supp.1988). Thus, state and local employees could avoid Arizona taxation altogether on retirement benefits, regardless of whether these benefits derived from employers' contributions or employees' contributions. In 1989, however, *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), held that a similar Michigan statute violated principles of intergovernmental tax immunity, by favoring retired state and local governmental employees over federal employees, who were not allowed to deduct retirement benefits from their taxable Michigan income.

The Arizona legislature promptly reacted to *Davis* by amending A.R.S. § 43-1022(3) to eliminate benefits received from state and local retirement plans from the list of permitted subtractions from Arizona gross taxable income.[5] 1989 Ariz. Sess. Laws, ch. 312, § 12. The same statute also removed from the list of statutory subtractions contributions to ASRS, EORP, and county or city retirement plans. *Id.* In 1991, the legislature removed mandatory contributions to CORP and PSPRS from its list of subtractions from Arizona gross income. 1991 Ariz. Sess. Laws, ch. 155, § 8 (retroactively effective to January 1, 1991).

Thus, for tax years after 1990, Arizona law has not provided for subtraction from gross income for mandatory employee contributions to any state or local retirement plans and it has treated benefits received from federal, state or local plans similarly. This did not mean, however, that all employee contributions were immediately subjected to current Arizona tax.

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[5] At the same time, the legislature amended § 43-1022 to allow the annual deduction of up to $2500 of retirement benefits received by the taxpayer from either state or federal retirement systems. 1989 Ariz. Sess. Laws, ch. 312, § 12 (now codified at A.R.S. § 43-1022(2) (Supp.2003)).

Beginning in 1985, the legislature had enacted statutes authorizing certain state retirement plans to "pick up" employee contributions pursuant to I.R.C. § 414(h)(2). 1985 Ariz. Sess. Laws, ch. 294, § 4 (now codified at A.R.S. § 38-736(B) (2001) (authorizing ASRS pick up)); 1985 Ariz. Sess. Laws, ch. 309, § 4 (now codified at A.R.S. § 38-810(E) (2001) (authorizing EORP pick up)); 1986 Ariz. Sess. Laws, ch. 325, § 1 (now codified at A.R.S. § 38-892 (2001) (authorizing CORP pick up)). Prior to 1989, ASRS and EORP had already opted to pick up employee contributions pursuant to § 414(h)(2); these contributions were therefore not included in federal AGI, and thus not subject to current Arizona tax, notwithstanding the elimination of the previous subtractions in 1989.[6]

Although CORP had received legislative authorization to pick up employee contributions in 1986, it did not elect to do so immediately; its pick up was first effective on July 1, 2000. PSPRS did not receive legislative authorization to pick up employee contributions until 1999, 1999 Ariz. Sess. Laws, ch. 50, § 4; 1999 Ariz. Sess. Laws, ch. 327, § 22 (now codified at A.R.S. § 38-843.01 (2001)), and its election

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[6] In addition to the subtractions from income previously set forth in A.R.S. § 43-1022(2) for contributions to state retirement plans, the statutes governing ASRS and EORP have long provided that member contributions "are exempt from state, county and municipal taxes." 1953 Ariz. Sess. Laws, ch. 128, § 22 (now codified at A.R.S. § 38-792(A) (2001) (ASRS)); 1985 Ariz. Sess. Laws, ch. 309, § 4 (now codified at A.R.S. § 38-811 (2001) (EORP)). The same statutes also previously exempted from state taxation benefits received from these funds; those exemptions were removed in 1989 in the same law that eliminated the authorization for subtractions from income. *See* 1989 Ariz. Sess. Laws, ch. 312, § 6 (ASRS); *id.* § 8 (EORP). Presumably, the legislature did not remove the exemption of the member contributions in 1989 in light of the preexisting pick ups under § 414(h)(2) by ASRS and EORP.

was effective at the same time as CORP's.[7] Thus, throughout the period from 1989 to 2000, the thousands of state and local employees covered by these two plans paid current Arizona income tax on their employee contributions.[8]

C. The § 1983 Action

Respondents are Arizona taxpayers, each of whom was employed by the federal government and who paid state income taxes on mandatory contributions to federal retirement plans. *See Kerr I*, 183 Ariz. at 4, 899 P.2d at 165. In 1989, respondents filed a class action under 42 U.S.C. § 1983 against the Arizona Department of Revenue ("ADOR") and ADOR officials, alleging that Arizona's income tax scheme violated the intergovernmental tax immunity doctrine codified in the Public Salary Tax Act of 1939, 4 U.S.C. § 111(a), by treating the employee contributions of federal employees differently than those of state employees. *Kerr I*, 183 Ariz. at 4, 899 P.2d at 165.[9] Respondents challenged both former A.R.S. § 43-1022(2), under which all employee contributions (even if not picked

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[7] Until 1989, the statutes governing CORP and PSPRS, like the statutes then governing ASRS and EORP, provided that both benefits received from, and employee contributions to, these plans were exempt from state taxation. A.R.S. § 38-852 (1985) (PSPRS); A.R.S. § 38-896 (Supp.1986) (CORP). In 1989, the legislature removed the exemption for benefits from these statutes. 1989 Ariz. Sess. Laws, ch. 312, § 9 (PSPRS); *id.* § 10 (CORP). In 1991, the legislature removed the exemption for employee contributions from the governing statutes. 1991 Ariz. Sess. Laws, ch. 155, § 2 (PSPRS); *id.* § 6 (CORP).

[8] As of June 30, 2001, some 26,520 state employees were enrolled in PSPRS and CORP. Resp. Sep.App. Tab 9. This number was approximately thirteen percent of the total state employee population. *Id.*

[9] The putative class included respondents and all Arizona taxpayers employed by the federal government who paid state income tax on their mandatory retirement contributions. *Kerr I*, 183 Ariz. at 4, 899 P.2d at 165.

up by employers) could be subtracted from Arizona taxable income, and the use in current § 43-1001(2) of federal AGI as the base for Arizona taxable income, because it allowed state employees whose contributions were picked up to avoid current taxation. *Kerr I*, 183 Ariz. at 5, 899 P.2d at 166.

The tax court held that the former version of § 43-1022(2) violated § 111(a). *Id.* at 13-14, 899 P.2d at 174-75. It rejected, however, the taxpayers' attack on § 43-1001(2), holding that any disparity resulting from the application of I.R.C. § 414(h)(2) to determine federal AGI did not violate the intergovernmental tax immunity doctrine. *Id.* at 14-15, 899 P.2d at 175-76. The court of appeals affirmed the tax court with respect to former § 43-1022(2), *id.* at 16-17, 899 P.2d at 177-78, but reversed with respect to § 43-1001(2), holding that the effect of adopting federal AGI was to discriminate against federal employees in favor of state employees whose employers had picked up the employee contributions. *Id.* at 14-15, 899 P.2d at 175-76.

After ADOR petitioned for review we vacated *Kerr I* and remanded for reconsideration in light of *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582, 585, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995), which held that before suing under § 1983, plaintiffs must first exhaust all "adequate remedies." On remand, the court of appeals held that these plaintiffs had failed to exhaust their state administrative remedies and remanded to the tax court with instructions to dismiss the § 1983 action. *Kerr II*, 185 Ariz. at 467, 916 P.2d at 1183.

D. The Refund Suit

At the same time that they instituted the § 1983 action, respondents filed administrative claims with ADOR on behalf of themselves and the class requesting refunds based on Arizona's allegedly unconstitutional tax scheme. *See Kerr III*, 197 Ariz. at 215 ¶ 6, 3 P.3d at 1135. An ADOR hearing

officer held that the agency had "no legal authority to pass on the legality of the statutory scheme or to recognize a class refund claim." *Id.* Respondents appealed to the Board of Tax Appeals ("BOTA"), which held that neither ADOR nor BOTA had authority to entertain class refund claims. *Id.* ¶ 7. As to respondents' individual claims, BOTA held that the adoption of federal AGI in § 43-1001(2) did not violate the intergovernmental tax immunity doctrine and therefore refused to grant refunds for tax years after 1990. *See Kerr IV*, 201 Ariz. at 129 ¶ 11, 32 P.3d at 412. BOTA, however, held that those respondents who were parties to the administrative proceedings should be granted refunds for taxes paid on their mandatory contributions from 1985 through 1990. *Id.* at 128-29 ¶ 11, 32 P.3d at 411-12.[10] The governor thereafter directed ADOR to make refunds for the tax years from 1985 to 1990 to all taxpayers who had filed timely refund claims, whether or not they were parties to the administrative action. *Id.* at 129 ¶ 12, 32 P.3d at 412.[11]

Respondents then sought review of the BOTA rulings in the tax court. That court denied respondents' motion to certify a class consisting of "all current and former federal employees who paid Arizona income taxes on contributions they made to United States Government retirement plans from 1984 to the present who have not received refunds of such taxes." *Kerr IV*, 201 Ariz. at 129 ¶ 13, 32 P.3d at 412. The court also denied the taxpayers' "alternative motion to

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[10] In June 1998, the tax court awarded respondents' attorneys twenty percent of each refund as fees. The court of appeals affirmed that award. *Kerr III*, 197 Ariz. at 220, 3 P.3d at 1140.

[11] ADOR later ruled that "taxpayers who were taxed on mandatory retirement contributions to retirement plans maintained by the federal government" for tax years prior to 1991 and who timely filed amended returns, refund claims, or protective claims, were entitled to a refund of excess amounts paid in those years. Ariz. Individual Income Tax Ruling 98-1, *available at* http://www.revenue.state.az.us/rulings/itr98-1.htm.

certify a class of all federal employees who filed timely refund claims for one or more years from 1991 to the present." *Id.* The tax court, however, held that the use of federal AGI as the Arizona tax base in § 43-1001(2) violated § 111(a) because its effect was to discriminate against federal employees in favor of state employees. *Id.* ADOR appealed and respondents cross-appealed.

In *Kerr IV*, concluding the reasoning of *Kerr I* was "incomplete and ultimately incorrect," 201 Ariz. at 130 ¶ 18, 32 P.3d at 413, the court of appeals rejected respondents' attack on § 43-1001(2) and thus rejected any claims for refunds for tax years after 1990. *Id.* at 131 ¶ 22, 32 P.3d at 414. The court held that the Arizona taxing scheme did not violate § 111(a), because it did not discriminate "'because of the [federal or state] source of pay or compensation.'" *Id.* (quoting 4 U.S.C. § 111(a)). *Kerr IV* concluded that the Arizona scheme "distinguishes not between state and federal employees, but rather between all those whose employers make or pick up their mandatory contributions and all those whose employers do not." *Id.* ¶ 26.

With respect to tax years 1985 through 1990, *Kerr IV* affirmed the tax court's conclusion that certification of a class of those whose refund claims had been denied would be redundant and unnecessary. *Id.* at 133 ¶¶ 33-34, 32 P.3d at 416. As to those in the putative class who had not filed written refund claims, relying on *Arizona Department of Revenue v. Dougherty*, 198 Ariz. 1, 6 P.3d 306 (App.2000) ("*Ladewig I*"), the court of appeals held that the tax court acted within its discretion in denying class status to those taxpayers who had failed to exhaust applicable statutory administrative remedies. *Kerr IV*, 201 Ariz. at 133 ¶ 35, 32 P.3d at 416.

Shortly after the court of appeals issued *Kerr IV*, we held in *Arizona Department of Revenue v. Dougherty*, 200 Ariz. 515, 29 P.3d 862 (2001) ("*Ladewig II*"), that a class action can be

used as a vehicle for bringing and exhausting certain administrative claims. Respondents then moved for reconsideration of the class action rulings in *Kerr IV* with respect to tax years 1985 through 1990 in light of *Ladewig II*; they also sought reconsideration of the court of appeals' substantive rejection of their claims with respect to tax years after 1990.

The court of appeals granted the motion for reconsideration and issued the opinion now under review, *Kerr V*, 204 Ariz. 485, 65 P.3d 434. In *Kerr V*, the court of appeals held that its analysis in *Kerr IV* rested on a "narrow, mistaken application of the literal language of 4 U.S.C. § 111." *Id.* at 491 ¶ 23, 65 P.3d at 440. Because the effect of § 43-1001(2) for tax years after 1990 was to require federal employees to pay current Arizona income tax on their mandatory contributions, while deferring such taxation for state and local employees, the court of appeals held that United States Supreme Court case law interpreting § 111(a) mandated that the Arizona scheme be struck down unless it was justified by "'significant differences' " between these classes. *Id.* (quoting *Davis*, 489 U.S. at 815-16, 109 S.Ct. 1500). Finding none, *Kerr V* concluded that § 43-1001(2) violated the intergovernmental tax immunity doctrine. *Id.* at 493-95 ¶¶ 28-37, 65 P.3d at 442-44. As to class action issues, the court of appeals determined that it was best to allow the tax court "a fresh look" in light of *Ladewig II*, and remanded to the tax court for reconsideration of these issues. *Id.* at 496-97 ¶ 46, 65 P.3d at 445-46.

ADOR petitioned for review only on the intergovernmental tax immunity issue. We granted review because of the obvious statewide importance of the issue. We have jurisdiction pursuant to Article 6, Section 5(3) of the Arizona Constitution, Arizona Rule of Civil Appellate Procedure 23, and A.R.S. § 12-120.24 (2003).

II.

The intergovernmental tax immunity doctrine has its genesis in *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579 (1819), which held that Maryland could not impose a tax on the Bank of the United States. *See Davis*, 489 U.S. at 810, 109 S.Ct. 1500. Until 1938, the doctrine was expansively interpreted to prohibit state and federal governments from taxing the salaries of the other's employees. *See Jefferson County v. Acker*, 527 U.S. 423, 436, 119 S.Ct. 2069, 144 L.Ed.2d 408 (1999), and cases cited therein.

In the late 1930s, however, the doctrine underwent a significant "contraction," *id.* at 436 n. 6, 119 S.Ct. 2069, at the hands of the Supreme Court. First, in *Helvering v. Gerhardt*, 304 U.S. 405, 58 S.Ct. 969, 82 L.Ed. 1427 (1938), the Court held that the federal government could tax the salaries of employees of the Port of New York Authority. Then, in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 59 S.Ct. 595, 83 L.Ed. 927 (1939), the Court expressly overruled a number of prior decisions and held that a state's imposition of an income tax on the salaries of federal employees placed no unconstitutional burden on the federal government. Since *Graves*, the Supreme Court has proclaimed "a narrow approach to governmental tax immunity." *United States v. New Mexico*, 455 U.S. 720, 735, 102 S.Ct. 1373, 71 L.Ed.2d 580 (1982). Case law after *Graves* has made plain that the doctrine "barred only those taxes that were imposed directly on one sovereign by the other or that discriminated against a sovereign or those with whom it dealt." *Davis*, 489 U.S. at 811, 109 S.Ct. 1500.

In its decisions contracting the intergovernmental tax immunity doctrine, the Supreme Court has "recognized that the area is one over which Congress is the principal superintendent." *Jefferson County*, 527 U.S. at 425, 119 S.Ct. 2069. Shortly after *Graves* was announced, Congress adopted the Public Salary Tax Act of 1939, "the primary purpose of

which was to impose federal income tax on the salaries of all state and local governmental employees." *Davis*, 489 U.S. at 810, 109 S.Ct. 1500. But, "concerned that considerations of fairness demanded equal tax treatment for state and federal employees," Congress also expressly waived in § 4 of the 1939 Act "whatever immunity would have otherwise shielded federal employees from nondiscriminatory state taxes." *Id.* at 812, 109 S.Ct. 1500. Section 4, codified at 4 U.S.C. § 111(a), provides that "[t]he United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States," but only "if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." Section 111(a) thus "codified the result in *Graves*," and foreclosed subsequent broader judicial interpretation of the intergovernmental tax immunity doctrine. *Davis*, 489 U.S. at 812, 109 S.Ct. 1500. The Supreme Court has held that the immunity provided in § 111(a) is "coextensive with the prohibition against discriminatory taxes embodied in the modern constitutional doctrine of intergovernmental tax immunity." *Id.* at 813, 109 S.Ct. 1500.

A.

The initial inquiry under § 111(a) is whether a challenged state tax discriminates against federal employees "because of the source" of their compensation. If the alleged discrimination is not because of the federal source of income, but rather for some other reason, there is no violation of the intergovernmental tax immunity doctrine. *See Jefferson County*, 527 U.S. at 442-43, 119 S.Ct. 2069 (holding that a facially nondiscriminatory Alabama occupational tax exempting those who held licenses under other state or county laws did not violate § 111(a), notwithstanding the fact that the plaintiff federal judges could never qua for exemption, because the tax "does not discriminate against federal judges in particular, or federal officeholders in general, based on the federal *source* of their pay or

compensation"); *Cheatham v. Eagerton*, 703 So.2d 389, 391 (Ala.Civ.App.1997) (holding that exemption of state law enforcement officers' per-diem subsistence allowance from state taxation did not violate § 111(a), notwithstanding that federal officers received no comparable allowance, because the tax scheme does not discriminate because of the "source" of the pay or compensation).

When the state scheme does discriminate because of the federal source of pay, the cases require a second level of analysis. Imposition of a heavier burden on federal employees because of the source of pay may be justified only by "significant differences between the two classes." *Davis*, 489 U.S. at 815-16, 109 S.Ct. 1500 (quoting *Phillips Chem. Co. v. Dumas Indep. Sch. Dist.*, 361 U.S. 376, 383, 80 S.Ct. 474, 4 L.Ed.2d 384 (1960)). In determining whether this standard of justification is met, decisions in the equal protection field "are not necessarily controlling." *Id.* at 816, 109 S.Ct. 1500. Rather, the inquiry is whether the inconsistent tax treatment "is directly related to, and justified by, 'significant differences between the two classes.'" *Id.* (quoting *Phillips*, 361 U.S. at 383-85, 80 S.Ct. 474).

B.

The opinion below passed quickly over the first level of analysis required under § 111(a). The court of appeals apparently started from the premise that because the adoption of federal AGI as the Arizona income tax base in § 43-1001(2) effectively required respondents to pay current tax on their employee contributions while deferring taxation for state and local employees whose contributions had been picked up under I.R.C. § 414(h)(2), the Arizona scheme necessarily discriminated against respondents *because of* the federal source of their pay. *Kerr V*, 204 Ariz. at 491-92 ¶ 24, 65 P.3d at 440-41.

We reach a contrary conclusion. At the outset, it is worth noting that every Supreme Court decision cited by respondents in which a state tax was found to violate § 111(a) or the intergovernmental tax immunity doctrine involved a tax statute which discriminated on its face against federal employees or federal property. For example, in *Davis*, Michigan law provided a deduction for retirement benefits paid by the state or its political subdivisions, but not for benefits paid by others, including the federal government. *Davis*, 489 U.S. at 805, 109 S.Ct. 1500; *id.* at 814, 109 S.Ct. 1500 ("It is undisputed that Michigan's tax system discriminates in favor of retired state employees and against retired federal employees."). Similarly, the Kansas tax scheme struck down in *Barker v. Kansas*, 503 U.S. 594, 112 S.Ct. 1619, 118 L.Ed.2d 243 (1992), provided a statutory deduction for benefits received by various state and federal retirees, but no deduction for military retirement benefits. *Id.* at 596, 112 S.Ct. 1619. And, the Texas scheme invalidated in *Phillips* expressly treated lessees of state land differently than other lessees, including lessees of federal property. 361 U.S. at 379-80, 80 S.Ct. 474. Thus, each of these cases quickly concluded that the challenged tax scheme discriminated because of the federal source of pay, and focused almost exclusively on whether such discrimination was justified by significant differences between the disadvantaged federal plaintiffs and the advantaged class.

In contrast, § 43-1001(2) contains no overt discrimination against any taxpayer because of the source of pay. Every Arizona taxpayer, whether employed by the federal government, the State, a political subdivision, or a private employer, begins with federal AGI as the Arizona income tax base. And, in contrast to the situation that obtained for tax years before 1991, Arizona law no longer provides for subtraction from that base of contributions made by state employees, while denying such subtraction to federal employees.

Respondents have not identified any Supreme Court decision in which a facially neutral state tax scheme was found to have violated the intergovernmental tax immunity doctrine. Respondents' citation to *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S.Ct. 692, 74 L.Ed.2d 562 (1983), as an example of such a case is unavailing.[12] The Tennessee business tax at issue in *Memphis Bank*, like the Arizona income tax code, started with a federal AGI base. *Id.* at 394 & n. 3, 103 S.Ct. 692. But a Tennessee statute then added to the base all income derived from obligations of states other than Tennessee. *Id.* Because federal AGI already included obligations of the United States, *see* I.R.C. § 103, the Tennessee law thus provided an express exemption from taxation for income from bonds issued by Tennessee and its political subdivisions, while taxing similar obligations issued by the United States and all other states. *Id.* The Tennessee statutory scheme thus expressly differentiated between interest received on that state's obligations and all other obligations, including those of the federal government.[13]

Respondents argue that even if there is no facial discrimination in § 43-1001(2), we must examine the "practical operation" of the Arizona scheme. *See Phillips*, 361 U.S. at 383, 80 S.Ct. 474. We agree. If the inevitable consequence

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[12] *Memphis Bank* did not involve an income tax, and thus did not interpret § 111(a). Rather, the statute involved was 31 U.S.C. § 742, which allows nondiscriminatory franchise or other non-property taxes to be imposed on federal obligations or interest therefrom. *Memphis Bank*, 459 U.S. at 395-96, 103 S.Ct. 692. However, because § 742, like § 111(a), is a "restatement of the constitutional rule" of intergovernmental tax immunity, the analysis under each section is functionally the same. *Id.* at 396-97, 103 S.Ct. 692.

[13] *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992), upon which respondents also rely, is even further afield. That case did not interpret the intergovernmental tax immunity doctrine, but rather the Foreign Commerce Clause, U.S. Const. art. 1, § 8, cl. 3.

of a facially neutral state tax code were that federal employees were taxed differently than similarly situated state employees because of the source of their income, or if the distinctions drawn in the state code were "only a cloak for discrimination against federally funded [pay or compensation]," *Barker*, 503 U.S. at 604-05, 112 S.Ct. 1619, § 111(a) would plainly invalidate such a scheme. But this is not such a case. In "practical operation," § 43-1001(2) does not require that federal employees be taxed differently than state employees with respect to mandatory retirement contributions. Arizona taxes the employee contributions of those state employees whose contributions have not been picked up by their employers in precisely the same fashion as it treats the employee contributions of federal employees.

The distinction is not simply theoretical; it has had real practical effects on Arizona taxpayers. As noted above, from 1990 through 2000, the majority of the tax years covered by this litigation, the employee contributions of the thousands of state and local employees covered by PSPRS and CORP were not picked up, and each of these employees therefore paid current state tax on those contributions. While the treatment of numerous state and local employees in a fashion identical to the allegedly disadvantaged federal employees may not itself conclusively prove that a state scheme does not violate § 111(a), it surely demonstrates that the Arizona scheme is not simply a "cloak for discrimination."

More importantly, nothing in the Arizona scheme discriminates between taxpayers based on the federal or non-federal source of income; the distinction is instead based on whether a particular governmental employer has voluntarily opted to pick up the employee contributions and treat them as employer contributions. Section 414(h)(2) is permissive; it treats employee contributions as employer contributions for federal tax purposes only if the employer voluntarily opts for such treatment.

Respondents argue that because § 414(h)(2) only authorizes state and local governmental employers to pick up employee contributions, the effective distinction in § 43-1001(2) between those employers who pick up and those who do not necessarily discriminates against federal employees. This argument, however, takes far too narrow a view of the national government and the choices it has made. Section 414(h)(2) simply gave state and local employers the option to choose to pick up; without advance federal authorization, they could never choose to do so. The federal government, however, already had that option and, through its legislative branch, can exercise that option at any time it desires. In "practical operation," the federal government has thus far simply voluntarily opted not to pick up, just as some state employers voluntarily so opted in Arizona throughout the 1990s. Once the state employers made the choice to pick up, their employees' contributions were treated identically to those of governmental employers who had previously made this election. When and if the federal employer makes the same choice, Arizona tax law will treat its employees' contributions in an identical fashion.

In short, § 43-1001(2) is not a subterfuge for discrimination against respondents because of their federal source of pay, nor is Arizona's treatment of respondents' employee contributions a necessary consequence of their federal status. Rather, the difference is not who pays the employees, but the voluntary choice made by the employer as to whether the contributions should be picked up.

Cases dealing with military retirement benefits are particularly instructive on this point. *Barker* invalidated a Kansas tax scheme which allowed subtraction of various retirement benefits, both state and federal, from taxable income, because the statutes did not permit benefits received by retired federal military personnel to be deducted. *Barker*, 503 U.S. 594, 112 S.Ct. 1619, 118 L.Ed.2d 243. In contrast,

Cooper v. Commissioner of Revenue, 421 Mass. 557, 658 N.E.2d 963 (1995), decided some three years after *Barker*, upheld a Massachusetts statutory scheme which exempted from taxation retirement benefits received from any governmental pension fund to which the taxpayer contributed during employment, while taxing benefits received from all other plans. The federal military retirement pension system involved no employee contributions, and all military retirees were thus subjected to Massachusetts income tax on their benefits. *Id.* at 964. The "practical operation" of the Massachusetts plan, at least with respect to military retirees, was thus identical to the Kansas scheme. Nonetheless, *Cooper* held that any differing treatment of military retirees from other government retirees in Massachusetts was not because of the "source of pay," but rather because the federal government had designed their plan as non-contributory. *Id.* Because all non-contributory plans were treated equally—even though virtually all Massachusetts employees now participated in contributory plans[14]—any differing treatment was not because of the source of the military retirees' income, but rather because of a separate, non-pretextual, distinction. *Id.*[15]

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[14] Massachusetts established its contributory retirement system in 1936 and 1937. *Cooper*, 658 N.E.2d at 965. Thus, it was doubtful that any current state retiree participated in a non-contributory system, although the Supreme Judicial Court so assumed for purposes of analysis in *Cooper*. *Cf. Filios v. Comm'r of Rev.*, 415 Mass. 806, 615 N.E.2d 933, 936 (1993) (noting theoretical possibility that state employee participants in old non-contributory plans were still alive).

[15] Respondents argue that *Cooper* is no longer good authority because the Massachusetts legislature has since changed the statutory tax scheme to exempt military retirement pay from state taxation. *See* Mass. 1987 Legis. Serv., ch. 139 (amending Mass. Gen. Laws Ann. ch. 62, § 2(a)(2)(E)). But nothing in the federal governmental tax immunity

The same is true here. Arizona tax law effectively distinguishes between taxpayers whose governmental employers choose to pick up employee contributions and those whose governmental employers do not choose to do so. That distinction is not "because of the source" of the employee's compensation and therefore does not run afoul of the intergovernmental tax immunity doctrine.[16]

III.

For the reasons above, we hold that the court of appeals erred in *Kerr V* in concluding that the application of § 43-1001(2) to respondents violated the intergovernmental tax immunity doctrine codified in § 111(a). We therefore vacate the opinion below insofar as it so held and reverse the judgment of the tax court to the same extent. Because ADOR did not seek review of that portion of the opinion below remanding the class certification issue with respect to tax years 1985 through 1990 to the tax court for further consideration in light of *Ladewig II*, we do not address that portion of the opinion below.[17] This case is remanded to the tax court for further proceedings consistent with this opinion.

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doctrine prevents a state from exchanging one non-discriminatory scheme for another, and we do not ordinarily infer any invalidity in a statute from subsequent legislative amendment.

[16] Because we conclude that use of federal AGI as the Arizona tax base in § 43-1001(2) does not violate the intergovernmental tax immunity doctrine, we do not need to consider whether in this case any discrimination is justified by substantial differences between respondents and state governmental employees. *Cf. Witte v. Dir. of Rev.*, 829 S.W.2d 436 (Mo.1992) (upholding Missouri tax scheme which imposed current taxation on employee contributions to federal Civil Service Retirement System, while deferring taxation to other retirement plans, because of plaintiffs' failure to show a lack of significant differences between the two classes).

[17] Our disposition of the intergovernmental tax immunity issue moots any question as to whether class certification should have been granted with respect to claims relating to tax years after 1990.

CONCURRING: CHARLES E. JONES, *Chief Justice*, RUTH V. McGREGOR, *Vice Chief Justice*, MICHAEL D. RYAN, *Justice*, and JOHN PELANDER, *Judge*.[18]

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[18] The Honorable Rebecca White Berch recused herself; pursuant to Article VI, Section 3 of the Arizona Constitution, the Honorable JOHN PELANDER, Judge of the Court of Appeals, Division Two, was designated to sit in her stead.

APPENDIX B

COURT OF APPEALS OF ARIZONA
DIVISION 1, DEPARTMENT T

No. 1 CA-TX 00-0023

CLARK R. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN and JOHN UDALL, individually and as representatives of the class comprised of federal employees who paid Arizona income taxes on federal retirement contributions during one or more of the years 1984 to date,

Plaintiffs-Appellees,
Cross Appellants,

v.

MARK J. KILLIAN, in his capacity as Director of the Arizona Department of Revenue, the Arizona Department of Revenue of the State of Arizona,

Defendants-Appellants,
Cross-Appellees.

STATE OF ARIZONA, *ex rel.*,
the Arizona Department of Revenue,

Plaintiff-Appellant,
Cross-Appellee,

v.

CLARK J. KERR and BILLIE SUE KERR, husband and wife,

Defendants-Appellees,
Cross-Appellants.

CLARK J. KERR and BILLIE SUE KERR, husband and wife; and their Attorneys, BONN, LUSCHER, PATTEN & WILKINS, Chartered and O'NEIL, CANNON & HOLLMAN, S.C.,
Counterclaimants-Appellees, Cross-Appellants,

v.

STATE OF ARIZONA, *ex rel.*, the Arizona Department of Revenue,
Counterdefendant-Appellant, Cross-Appellee.

Aug. 28, 2001
As Amended Feb. 27, 2003.

AMENDED OPINION

PATTERSON, *Presiding Judge.*

We issued our original opinion in this appeal on August 28, 2001. *Kerr v. Killian*, 201 Ariz. 125, 32 P.3d 408 (App. 2001). On August 29, 2001, our supreme court decided *Arizona Department of Revenue v. Dougherty*, 200 Ariz. 515, 29 P.3d 862 (2001). Based largely on *Dougherty*, plaintiffs-appellees/cross-appellants Clark R. Kerr and Billie Sue Kerr, Susan Moran, Steve Allen, and John Udall ("the plaintiff taxpayers") moved for reconsideration. We directed defendants-appellants/cross-appellees Arizona Department of Revenue and its director, Mark J. Killian ("ADOR") to file a response to the motion for reconsideration, and permitted the plaintiff taxpayers to file a reply. We now grant the motion for reconsideration, amend our original opinion, and file this modified opinion.

I. BACKGROUND AND ISSUES

For tax years from 1991 onward, Arizona Revised Statutes ("A.R.S.") section 43-1001(2) (1998 and Supp.2002) sub-

jects to Arizona individual income taxation those portions of federal employees' compensation that they are required to contribute toward federal employee retirement plans, while leaving untaxed the corresponding mandatory contributions of state employees to state employee retirement plans. The superior court held that A.R.S. § 43-1001(2) violated the Public Salary Tax Act of 1939, 4 U.S.C. § 111,[1] to that extent.[2] ADOR appeals.

The plaintiff taxpayers cross-appeal from the superior court's orders denying certification of a plaintiff class consisting of all current or former federal employees who paid Arizona income taxes on mandatory contributions to federal retirement plans during one or more years from 1985 to the present, and of an alternative, smaller class consisting of all such federal employees who also filed timely refund claims with ADOR for one or more of the years 1991 to the present. The appeal and cross-appeal present these issues:

> 1. Whether Arizona's income taxing scheme violates 4 U.S.C. § 111 by taxing those portions of federal employees' compensation that they are required to contribute to retirement plans, but not the corresponding portions of state employees' compensation;

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[1] The pertinent text of 4 U.S.C. § 111 is:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation. This legislation is effectively a codification of the constitutional intergovernmental tax immunity doctrine and is interpreted according to the development of that doctrine. *See generally Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 810-15, 109 S.Ct. 1500, 1505-07, 103 L.Ed.2d 891 (1989).

[2] Section 43-1001(2) has a multitude of other effects on every Arizona individual income taxpayer. None of these effects is challenged in this litigation.

2. Whether the superior court erred or abused its discretion in denying the plaintiff taxpayers' motions for class certification; and

3. Whether equal protection principles preclude ADOR from demanding compliance with an administrative claim requirement for taxpayers who initially paid the challenged taxes, while at the same time declining to pursue tax enforcement against other taxpayers who subtracted their mandatory federal retirement contributions on their Arizona returns and hence did not pay the challenged taxes.[3]

II. FACTS AND RELEVANT PROCEDURE

Until former A.R.S. § 43-1022(2) was amended in 1989, 1989 Ariz. Sess. Laws Ch. 312, § 12, that statute subtracted from Arizona gross income

> Contributions made to the state retirement system, the corrections officer retirement plan, the public safety

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[3] ADOR's opening brief also challenged the superior court's determination that the amended Arizona income tax return filed by plaintiffs Clark R. Kerr and Billie Sue Kerr for tax year 1984 sufficiently specified a claim for refund of Arizona income taxes they paid on plaintiff Clark Kerr's mandatory contributions to a federal employee retirement plan during that year. ADOR also challenged the court's decision to declare that the Kerrs' were entitled to an award of attorney's fees under the "common fund" theory. However, ADOR withdrew its challenge to the common fund award in its Consolidated Reply Brief and Answering Brief on Cross- Appeal. The plaintiff taxpayers' Reply Brief on Cross-Appeal also informed us that ADOR had withdrawn its contention that plaintiffs Kerr did not sufficiently claim a refund for tax year 1984, and that the plaintiff taxpayers had agreed to limit their appeal from the denial of class certification to tax years 1985 to the present. We therefore do not address these contentions.

personnel retirement system, the elected officials' retirement plan or a county or city retirement plan.[4]

Arizona law provided no corresponding subtraction for contributions made to federal employee retirement plans.

Since 1979, A.R.S. § 43-1001(2) has defined a resident individual's "Arizona gross income" as his/her federal adjusted gross income for the taxable year, computed under the Internal Revenue Code. *See* 1978 Ariz. Sess. Laws Ch. 213, § 2, eff. Jan. 1, 1979. Federal adjusted gross income is thus the starting point for determining an individual taxpayer's Arizona taxable income and ultimate income tax liability.

Effective in 1985, Arizona enacted provisions authorized by 26 U.S.C. § 414(h)[5] that permitted state and local gov-

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[4] The 1989 amendment eliminated the subtraction for contributions to the state retirement system, elected officials' retirement plans, and county and city retirement plans. A later amendment, 1991 Ariz. Sess. Laws Ch. 155, § 8, eliminated the remaining subtractions. For tax years 1979 through 1986, A.R.S. § 43-1022(2) also permitted subtraction of contributions to the judges' retirement fund. *See* 1978 Ariz. Sess. Laws Ch. 213, § 2. Effective July 1, 1986, that subtraction was repealed and the subtraction for contributions to the corrections officers' retirement fund was added in its place. *See* 1986 Ariz. Sess. Laws Ch. 325, §§ 3, 5.

[5] Section 414(h) provides:

> Tax treatment of certain contributions
>
> (1) In general
>
> Effective with respect to taxable years beginning after December 31, 1973, for purposes of this title, any amount contributed (A) to an employees' trust described in section 401(a), or (B) under a plan described in section 403(a), shall not be treated as having been made by the employer if it is designated as an employee contribution.
>
> (2) Designation of units of government
>
> For purposes of paragraph (1), in the case of any plan established by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the

ernmental employers to "pick up" mandatory contributions that their employees would otherwise have made. Because the portion of each employee's salary that was formerly earmarked for mandatory contribution to a retirement plan was no longer considered paid to the employee and contributed to the plan thereafter, those sums were automatically excluded from the employee's federal gross income. Congress has not chosen to make this benefit available to federal employees.

Consequently, by dint of A.R.S. § 43-1001(2), which defines a taxpayer's Arizona gross income as his/her federal adjusted gross income for the tax year, the Arizona gross incomes of federal employees include all sums they are required to contribute to their respective retirement plans. At the same time, the Arizona gross incomes of state and local employees whose employing units "pick up" their required retirement plan contributions necessarily exclude the amount of those contributions.[6] *See generally Kerr v. Waddell*, 183 Ariz. 1, 12-13, 899 P.2d 162, 173-74 (App.1994) ("*Kerr I*"), *vacated on other grounds*, 185 Ariz. 457, 916 P.2d 1173 (App.1996) ("*Kerr II*").

In 1989, the plaintiff taxpayers now before us brought an action, Tax Court Cause No. 89-01153, challenging the differential taxation effects of A.R.S. § 43-1001(2) and former A.R.S. § 43-1022(2). In *Kerr I*, this court held that their

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foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

[6] The fund managers of the Public Safety Personnel Retirement System and the Corrections Officer Retirement Plan have the power to authorize state and local employers to "pick up" the retirement contributions of members of those plans. A.R.S. § 38-843.01 through 38-843.04 (Supp. 2000); A.R.S. § 38-891 (1996). They did so June 30, 2000, during the pendency of this appeal.

state-law claims for refunds were barred by their failure to exhaust their administrative remedies before bringing the action, but that their claims for declaratory and injunctive relief under 42 U.S.C. § 1983 could proceed. 183 Ariz. at 8-11, 899 P.2d at 169-72. *Kerr I* also held that former §§ 43-1022(2) and 43-1001(2), as applied to state and federal employees, violated 4 U.S.C. § 111. 183 Ariz. at 14-17, 899 P.2d at 175- 78.

On petition for review our supreme court remanded for further consideration in light of *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995). On remand this court held that Arizona's administrative process for challenging the denial of tax refunds was an adequate state remedy within *National Private Truck Council*, and the plaintiffs' claims under 42 U.S.C. § 1983 were barred because they had failed to resort to and exhaust those remedies. *Kerr II*, 185 Ariz. at 464-67, 916 P.2d at 1180-83. We remanded the action to the tax court with directions to dismiss it in its entirety. *Id.*

Simultaneously with the filing of their 1989 action in the tax court, the plaintiff taxpayers filed corresponding administrative refund claims with ADOR on behalf of themselves and all other similarly situated federal employees. *Kerr v. Killian*, 197 Ariz. 213, 215, ¶ 6, 3 P.3d 1133, 1135 (App.2000) ("*Kerr III*"). In 1993, a hearing officer for ADOR determined that ADOR had no legal authority to rule on the legality of A.R.S. § 43-1001(2) and former A.R.S. section 43-1022(2), or to recognize a class refund claim. *Id.*

In 1994, during the pendency of *Kerr I* in this court, the Arizona Board of Tax Appeals heard the plaintiff taxpayers' administrative appeal from the ADOR hearing officer's adverse ruling. The matter remained under advisement with the Board until 1997, the year following the dismissal of the plaintiff taxpayers' first action pursuant to *Kerr II*. *Kerr III*,

197 Ariz. at 215, ¶ 7, 3 P.3d at 1135. The Board ruled that the plaintiff taxpayers were entitled to refunds for 1985 through 1990 because former A.R.S. § 43-1022(2) violated the intergovernmental tax immunity doctrine codified in 4 U.S.C. § 111. At the same time, the Board determined that A.R.S. § 43-1001(2) did not violate 4 U.S.C. § 111 and that no refunds for tax years after 1990 would be awarded. The Board also agreed with the ADOR hearing officer that neither ADOR nor the Board could entertain a class refund claim.

The plaintiff taxpayers and ADOR commenced the instant actions in April and May 1997 to appeal the Board's ruling. The plaintiff taxpayers alleged that they had "filed and pursued through the administrative process, a timely administrative class claim on their behalf and on behalf of all federal employees similarly situated." ADOR's answer admitted this allegation, but denied "that Plaintiffs were entitled to file or pursue a claim on behalf of anyone other than themselves."

In mid-1997, the Governor of Arizona directed ADOR "to make refunds for the tax years 1985 through 1990 to all taxpayers who had filed timely refund claims, whether they were parties to the administrative action or not." *Kerr III*, 197 Ariz. at 216, ¶ 8, 3 P.3d at 1136. *See* ADOR Arizona Individual Income Tax Ruling ITR 98-1. *at* http://www.revenue.state.az.us/rulings/itr98-1.htm. In June 1998, the tax court entered judgment under the common fund doctrine awarding the plaintiff taxpayers' attorneys 20% of each such refund for their fees. We affirmed that judgment. *Kerr III*, 197 Ariz. at 217-20, ¶¶ 19-32, 3 P.3d at 1137-40.

During the pendency of the appeal in *Kerr III*, the tax court denied plaintiff taxpayers' motion to certify a class consisting of all current and former federal employees who paid Arizona income taxes on compensation paid as contributions to United States Government retirement plans from 1984 to the present who have not received refunds of such taxes. Following the

analysis of our opinion in *Kerr I*, vacated in *Kerr II*, the court held that the application of A.R.S. § 43-1001(2) violated 4 U.S.C. § 111 to the extent it caused discriminatory state taxation of federal employees as compared to state and local governmental employees. The court also denied the plaintiff taxpayers' alternative motion to certify a class of all federal employees who filed timely refund claims for one or more years from 1991 to the present.

ADOR appeals, and the plaintiff taxpayers cross-appeal. We have jurisdiction under A.R.S. section 12 2101(B) (1994).

III. ANALYSIS

A. Differential Taxation of Retirement Plan Contributions

1. Standard of Review

On appeal from summary judgment the trial court's rulings on questions of law are reviewed *de novo*. *United Bank of Arizona v. Allyn*, 167 Ariz. 191, 195, 805 P.2d 1012, 1016 (App.1990).

2. A.R.S. § 43-1001(2) and 4 U.S.C. § 111

Under A.R.S. § 43-1001(2), the Arizona gross incomes of state and local employees, like those of federal employees and all other Arizona individual income taxpayers, are deemed to be the same amounts that are calculated as their adjusted gross incomes for the purpose of federal income taxation. As permitted by 26 U.S.C. § 414(h)(2), Arizona has adopted legislation enabling all state and local governmental employment units to elect to "pick up" their employees' mandatory retirement plan contributions. Those contributions are therefore excluded from the federal adjusted gross (Arizona gross) incomes of all employees of electing state and local governmental employment units. A.R.S. § 43-1001(2). Congress, however, has not authorized the United States Government to "pick up" federal employees' mandatory contributions to their retirement plans. The effect of A.R.S.

§ 43-1001(2) on federal employees is to sweep all such contributions into their Arizona gross incomes.

Arizona's individual income tax statutes make no adjustment to correct this differential Arizona income taxation of federal employees and state and local employees. There is no provision that adds back the sums representing state and local government employees' mandatory retirement contributions in the process of calculating their Arizona taxable incomes. They likewise contain no provision that subtracts the sums representing federal employees' mandatory retirement contributions in that same process. Through the 1990s until today, the practical result of this Arizona statutory scheme has been to tax the mandatory retirement plan contributions of all Arizona taxpayers who are federal employees, while sheltering from taxation the mandatory retirement plan contributions of all Arizona taxpayers who are employees of electing state and local governmental employment units.

In *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), the Supreme Court invalidated certain Michigan income taxing provisions that taxed retirement benefits paid by the United States Government while exempting retirement benefits paid by state and local governmental entities. The Court determined that the Michigan taxing scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine. The *Davis* court summarized the required mode of analysis as follows:

> Under our precedents, "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] must be justified by significant differences between the two classes." *Phillips Chemical Co. v. Dumas Independent School Dist.*, 361 U.S. [376], at 383 [80 S.Ct. 474, 4 L.Ed.2d 384] [1960]. In determining whether this

> standard of justification has been met, it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases. We have previously observed that "our decisions in [the equal protection] field are not necessarily controlling where problems of intergovernmental tax immunity are involved," because "the Government's interests must be weighed in the balance." *Id.*, at 385 [80 S.Ct. 474]. Instead, the relevant inquiry is whether the inconsistent tax treatment is directly related to, and justified by, "significant differences between the two classes." *Id.*, at 383-85 [80 S.Ct. 474].

489 U.S. at 816-17, 109 S.Ct. 1500. *Accord Barker v. Kansas*, 503 U.S. 594, 598, 112 S.Ct. 1619, 118 L.Ed.2d 243 (1992). The Court later held that *Davis* was to be applied retroactively. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 98, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993).

In his dissenting opinion in *Davis*, Justice Stevens argued that Michigan's challenged tax was nondiscriminatory and thus constitutional because it drew no distinction "between the federal employees or retirees and the vast majority of voters in the State." 489 U.S. at 823, 109 S.Ct. 1500. In footnote four to its opinion, the *Davis* Court responded:

> In *Phillips Chemical Co.*, however, we faced that precise situation: an equal tax burden was imposed on lessees of private, tax-exempt property and lessees of federal property, while lessees of state property paid a lesser tax, or in some circumstances none at all. Although we concluded that "[u]nder these circumstances, there appears to be no discrimination between the Government's lessees and lessees of private property," 361 U.S. at 381 [80 S.Ct. 474], we nonetheless invalidated the State's tax. This result is consistent with the underlying rationale for the doctrine of intergovernmental tax immunity. The danger that a State is engaging in impermissible discrimination against the Federal Govern-

> ment is greatest when the State acts to benefit itself and those in privity with it. As we observed in *Phillips Chemical Co.*, "it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself." *Id.* at 385 [80 S.Ct. 474].

489 U.S. 803, 815 n. 4, 109 S.Ct. 1500, 103 L.Ed.2d 891. *See also Barker*, (invalidating Kansas provisions taxing federal military retirement benefits while exempting state and local governmental employee retirement benefits on ground that no significant differences existed between the two retiree classes; ignoring Justice Stevens's attack on *Davis* in concurring opinion and his statement that: "A state tax burden that is shared equally by federal retirees and the vast majority of the State's citizens does not discriminate against those retirees.").

In our first opinion in the instant appeal, *Kerr v. Killian*, 201 Ariz. 125, 32 P.3d 408 (App.2001) ("*Kerr IV*"), we criticized as "incomplete and ultimately incorrect" this court's determination in *Kerr I* that the differential taxation of federal employees' mandatory retirement contributions and those of state and local governmental employees resulted from Arizona and not federal legislative action and therefore violated the intergovernmental tax immunity doctrine. *Kerr IV*, 201 Ariz. at 130, ¶ 18, 32 P.3d at 413.[7] Relying on *Davis* and *Jefferson County v. Acker*, 527 U.S. 423, 119 S.Ct. 2069,

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[7] We elaborated:

> The *Kerr I* court focused on whether the differing Arizona tax treatment of state and local governmental employees as compared to that of federal employees actually resulted from the operation of Arizona income tax statutes. *Kerr I* accordingly never directly addressed the more fundamental question of whether the differential Arizona tax treatment was actually "based on" the federal or state source of the pay or compensation.

201 Ariz. at 130, ¶ 18, 32 P.3d at 413.

144 L.Ed.2d 408 (1999), *Kerr IV* determined instead that the differential taxation of federal and state/local employees' mandatory retirement contributions did not violate the intergovernmental tax immunity doctrine codified as 4 U.S.C. § 111. We reasoned:

> Section 43-1001(2) disadvantages *all* Arizona resident individual taxpayers, private or governmental, who make mandatory retirement plan contributions that are not "picked up" or paid directly by their employers, over *all* Arizona resident individual taxpayers whose private or governmental employers pick up or directly pay their mandatory retirement contributions. Either of these groups may contain both state or local government employees and federal employees. The Arizona taxing scheme does not single out all or any subgroup of state or local governmental employees for advantageous treatment as against all others. It likewise does not single out all or any subgroup of federal employees for disadvantageous treatment as against all others. Under those circumstances, despite the fact that some state and local employees are taxed more favorably than federal employees and other Arizona income taxpayers by virtue of A.R.S. section 43-1001(2), we conclude as a matter of law that Arizona law does not discriminate against the plaintiff taxpayers or their putative class "because of the source of [their] pay or compensation" in violation of 4 U.S.C. § 111.

201 Ariz. at 131, ¶ 22, 32 P.3d at 414.

With the benefit of the parties' briefing on the plaintiff taxpayers' motion for reconsideration, we now recognize that we mistakenly based this analysis in part on a proposition of fact that the record does not support. Neither our own research nor the record supports the proposition that a private employer may choose to "pick up" its employees' mandatory

contributions[8] and thus exclude them from the employees' federal gross incomes. Federal law accords that privilege only to state and local government employers. 26 U.S.C. § 414(h).

More importantly, the overarching principle that drove our analysis in *Kerr IV* sprang from a narrow, mistaken application of the literal language of 4 U.S.C. § 111 without appropriate regard for the United States Supreme Court case law that both underpins and interprets that statute. Briefly stated, *Kerr IV* failed to recognize that under *Davis* and its progeny, the relevant inquiry is not into the rationale or the statutory mechanism under which a state differentially taxes federal employees and state/local government employees, or the overall effect of the state taxing scheme on other Arizona taxpayers in comparison to such employees, or even the question whether the state taxing scheme appears targeted toward benefitting state/local employees or disadvantaging federal employees in comparison to all other taxpayers. The relevant inquiry is instead whether the fact of differential state tax treatment of federal employees and state/local government employees is directly related to and justified by "significant differences" between those two classes. *Davis*, 489 U.S. at 815-16, 109 S.Ct. 1500.[9]

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[8] A substantial question exists concerning whether a private employer may adopt a mandatory retirement plan to which its employees must make specified employee contributions. We need not resolve that question for the purpose of our analysis here, and merely assume hypothetically that this is an option legally available to private employers.

[9] We also recognize that our reliance on *Acker* was misplaced. We cited that case as one in which the Supreme Court identified circumstances in which the intergovernmental tax immunity doctrine codified as 4 U.S.C. § 111 did not apply. We were correct in that assessment. We nevertheless failed to recognize that, unlike the situation here, the county license tax at issue in *Acker* had not been challenged as one that illegally imposed differential taxation on federal and state employees, but rather one that imposed an illegal direct tax on federal instrumentalities. It was

There is no question on this record that from 1990 to the present the Arizona taxing scheme has (1) required federal employees who reside in Arizona to pay Arizona individual income taxes on those portions of their employment compensation that they contribute to the federal retirement plans in which they are required to participate, while at the same time (2) effectively excusing most state and local governmental employees from paying such taxes on their own mandatory contributions to their corresponding state or local governmental retirement plans. Under *Davis* and its progeny, the only pertinent question is whether significant differences between these two classes exist that are directly related to and justify this differential treatment.

The principal focus of ADOR's opening and reply briefs on appeal was not on that question at all. Similar to its position in *Kerr I*, ADOR's principal thesis is that the differential taxation challenged in this case is not based on the "source" of the compensation in question, but rather on the federal tax status of the retirement plans to which federal, state, and local employees happen to be contributing. ADOR argues:

> The Arizona tax scheme does not discriminate based on the source of the income merely because it gives effect to choices made by the employer. The tax exclusion is not based on the source of the income, but on the qualification of the plan by the employer. All similarly situated employees are treated in the same manner. Any employee whose employer has a qualified plan that allows pre-tax contributions is treated in the same manner under Arizona tax law. This includes employees of governmental units and employees of private business

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in that context that the Court sustained the tax as one that did not discriminate against federal officeholders because of the federal "source" of their compensation. Contrary to our implicit conclusion in *Kerr IV*, Acker *does not change the* Davis *analysis as applied in the instant case*.

> entities. If a private employer chose to act as does the federal employer and not provide a pre-tax plan to its employees, the private employee contributions would similarly not be excluded from income. There is no discrimination.

For a number of reasons, we cannot agree with this analysis. First, ADOR's position is in essence that it is the particular federal, state, local, and private employers' choices concerning what kind of retirement plan to offer, and not the provisions of Arizona law, that produce the differential Arizona income taxation of federal employees' and state/local employees' mandatory contributions to retirement plans. This is essentially the same argument that we correctly rejected in *Kerr I* as follows:

> Both the tax court and the defendants err in relying upon "the source of the pay or compensation" to extricate Arizona's scheme for taxation of federal, state, and local retirement contributions from the prohibited category of discrimination. The thrust of defendants' reasoning is found in their statement that "[t]he only obstacle to the exclusion of federal plan contributions [from Arizona income taxation] is the federal employer, who has refrained from acting to 'pick up' contributions." Their implicit major premise, which is incorrect, is that Arizona had no choice other than to adopt federal adjusted gross income without modification as part of the state income tax scheme.
>
> Contrary to the tax court's ruling and [ADOR's] reasoning, however, it was ultimately Arizona legislative action that imposed the discriminatory tax scheme. In other words, it was not federal legislative action, but state legislative action that caused state and local retirement contributions to be exempted from Arizona income taxation while federal retirement contributions

were not. No provision of law to which we are cited required Arizona to adopt federal adjusted gross income in determining Arizona taxable income.

Further, as we observe above, the Arizona income tax scheme uses federal adjusted gross income only as its starting point. In arriving at Arizona adjusted gross income, some sixteen items of income are added to Arizona gross income, and twenty are subtracted from it. *See* A.R.S. §§ 43-1021 (Supp.1993) (additions to Arizona gross income); A.R.S. § 43-1022 (Supp.1993) (subtractions from Arizona gross income). For example, Arizona adds to gross income a taxpayer's interest income from non-Arizona political subdivisions, which the [Internal Revenue Code] excludes from federal income taxation. *See* A.R.S. § 43-1021(4). Similarly, Arizona subtracts from Arizona gross income all interest received on United States government obligations, and portions of social security benefits and railroad retirement benefits, which the federal government can tax but states cannot. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S.Ct. 692, 74 L.Ed.2d 562 (1983); 31 U.S.C. § 3124(a) (1988); 45 U.S.C. § 231m(a) (1988); A.R.S. §§ 43-1022(6), (17) (Supp.1993).

. . . Whatever the treatment accorded by federal law to federal and state retirement plan contributions, Arizona was not compelled to discriminate against federal employees.

Kerr I, 183 Ariz. at 15, 899 P.2d at 177. *Cf. Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev.*, 505 U.S. 71, 82, 112 S.Ct. 2365, 120 L.Ed.2d 59 (1992) (adoption of federal tax system in whole or in part does not shield statute from constitutional scrutiny).

More fundamentally, ADOR's analysis fails to recognize that under *Davis*, the purpose of the intergovernmental tax immunity doctrine is to protect the interests of the United States Government, and the government's interests must therefore be "weighed in the balance." *Davis*, 489 U.S. at 816, 109 S.Ct. 1500. The United States Congress has determined that federal entities are not to be accorded the choice to "pick up" their employees' mandatory retirement contributions and thereby exclude them from the employees' federal gross incomes. 26 U.S.C. § 414(h). As we understand *Davis* and the Supremacy Clause of Article VI of the United States Constitution, states must accept existing federal law as a "given." They cannot, as ADOR insinuates, simply treat Congressional policy as the mere equivalent of a private employer's choice as to what kind of retirement plan to offer its employees among those available under the law. Congressional policy as embodied by 26 U.S.C. § 414(h) is itself the law, and binds the states.

Equally important, ADOR's analysis also fails to recognize that under *Davis* the relevant inquiry is the existence *vel non* of significant differences between state/local employees and federal employees that directly relate to and justify Arizona's differential taxation of their mandatory retirement contributions. The "significant difference" between federal employees and state/local employees on which ADOR relies to support the existing Arizona tax scheme is Congress' choice to deny federal government employees the opportunity to exclude their mandatory retirement contributions from federal income taxation. But ADOR offers nothing that remotely tends to "justify" Arizona's own inertial choice to refrain from equalizing the burden of Arizona income taxation on the mandatory retirement contributions of federal employees and state/local employees. ADOR's analysis offers 26 U.S.C. § 414(h) merely as an explanation for the differential tax

treatment, not as a justification for it.[10] This is wholly insufficient to pass muster under *Davis* and its progeny.

In reality, there are no significant differences between the class of federal employees and the class of state and local employees as regards Arizona income taxation in this case. Members of both classes are required to contribute portions of their employment compensation to government-mandated retirement plans in which they are involuntary members as a legal consequence of their employment status. Under federal law, state and local governmental employers may and do elect to "pick up" their employees' mandatory retirement contributions and thus exclude the amounts of those contributions from their employees' federal gross incomes. Federal law does not permit federal government employing units to "pick up" their employees' mandatory retirement contributions. As a result, those amounts are included in federal employees' federal gross incomes along with the rest of their employment compensation.

Against that backdrop, Arizona has chosen to design its individual income taxing scheme in a way that includes federal employees' mandatory retirement contributions in their Arizona gross incomes, but excludes from Arizona gross income the corresponding mandatory retirement contributions of state and local employees. Congress' choice to discriminate against federal employees and in favor of state and local employees is not a significant difference in the characteristics of the two classes with respect to income taxation by the State of Arizona. It merely represents a difference in the treatment of the two groups under federal law for the purpose of federal income taxation.

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[10] As ADOR argues in its opening brief, Arizona law makes the tax treatment of employees dependent upon choice made by the retirement plan in which the employees participate. The federal employer has made a choice, and Arizona should not be required to twist its tax law to remove the tax consequences of that choice.

As we have said, Arizona has been free all along to adjust its statutes to equalize the treatment of the two groups for Arizona income tax purposes. It has chosen not to do so. It thereby violated the intergovernmental tax immunity doctrine as codified in 4 U.S.C. § 111 and interpreted by *Davis* and the cases following it.

Our reliance on *Cooper v. Commissioner of Revenue*, 421 Mass. 557, 658 N.E.2d 963 (1995), and *Witte v. Director of Revenue*, 829 S.W.2d 436 (Mo.1992), in *Kerr IV* in support of the contrary conclusion was misplaced. In *Cooper*, a Massachusetts statute exempted from state taxation all retirement benefits paid by annuity, pension, endowment, or retirement plans of the United States government, or state or local governmental employers, to which the recipient employee had contributed. Under this statute, any state, local or federal employee who had not contributed a portion of his/her salary to his/her retirement fund was required to pay state income taxes on his/her retirement benefits.

The plaintiff taxpayers in *Cooper* were military retirees whose retirement plans were funded entirely by the federal government. They claimed refunds of Massachusetts income taxes that they paid on their military retirement benefits. The Appellate Tax Board dismissed their claims.

The Supreme Judicial Court affirmed. The court reasoned:

> Massachusetts tax law distinguishes between contributory and noncontributory retirement plans, not between State and Federal retirees. "The determining factor for the Massachusetts exemption is whether the retirement fund is a 'contributory fund to which the employee has contributed.'" Technical Information Release (TIR) 89-6 (May 10, 1989), 2 Official MassTax Guide at 369 (West 1995). "Any Federal retirement income is exempt from Massachusetts tax if the system is contributory and the employee actually contributed," *id.*, and, on the other

> hand, "[a] non-contributory government pension, received by a retired employee of [a political subdivision of the Commonwealth] . . . is includible [sic] in the Massachusetts gross income of the employee . . . in the taxable year in which the pension is paid." Letter Ruling 81-51 (June 11, 1981), *supra* at 576. In sum, the statutory provisions treat retirement benefits paid by the Commonwealth and the Federal government in precisely the same way.

658 N.E.2d at 964.

In contrast, the "practical operation" of Arizona's taxing scheme, *see Phillips Chemical Company*, has required every federal employee who resides in Arizona to pay Arizona income taxes on his/her mandatory contributions to federal retirement plans, while allowing the mandatory retirement contributions of state and local employees to escape such taxation essentially by default. Unlike the situation in this case, the state taxing scheme in *Cooper* on its face treated both state and federal employees in the same way. In contrast, because the "pick up" option in 26 U.S.C. § 414(h) is extended to state and local governmental employers only, Arizona's taxing scheme results in a huge, unmistakable disparity in state income taxation as between federal employees and state/local employees. The *Cooper* court held that the provisions before it did not discriminate against federal retirees "either facially or in effect." 658 N.E.2d at 966. The effect of the Arizona taxing scheme in question here stands in stark contrast.

Witte is questionable authority. There, the court held that the plaintiff taxpayer had failed to carry his burden of proving that a Missouri statute allowing deduction of mandatory FICA contributions but not of federal Civil Service Retirement System contributions violated the intergovernmental tax immunity doctrine. The court stated: "The appellants have not shown the existence of a line of demarcation

between those who benefit from § 143.141 (allowing state deduction of FICA, railroad retirement, and self-employment taxes paid to federal government) and those who do not, based on a classification scheme that is, indeed, 'intergovernmental'". 829 S.W.2d at 439 n, 4. Upon reconsideration, we think the dissent by Senior Judge Blackmar, who would have invalidated the Missouri taxing scheme on the ground that it discriminated against one class of federal retirees and in favor of substantially all other taxpayers is the better reasoned opinion.

For the aforementioned reasons, we conclude that the superior court correctly determined that A.R.S. § 43-1001(2) and the Arizona resident individual income taxing scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine as applied to the plaintiff taxpayers.

B. Denial of Class Certification

In June 1997, two months after the plaintiff taxpayers commenced this litigation, the Governor of Arizona directed ADOR to make refunds for tax years 1985 through 1990 to all taxpayers who had filed timely refund claims, whether or not they had been parties to any administrative proceedings on those claims. *Kerr III*, 197 Ariz. at 216, ¶ 8, 3 P.3d at 1136. It is undisputed that ADOR took action to implement that order, though disputes arose concerning ADOR's refunding decisions in particular claimants' cases.

The plaintiff taxpayers later moved unsuccessfully to certify a class consisting of all current and former federal employees who paid Arizona income taxes on contributions they made to United States Government retirement plans from 1984 to the present who had not been paid refunds of such taxes. The relevant class would have encompassed all current or former federal employees who paid Arizona income taxes on their mandatory contributions to federal retirement plans and either (1) filed a refund claim that

ADOR denied, or (2) filed no refund claim at all. This putative class would have included all similarly situated federal employees who had paid Arizona income taxes on their mandatory retirement contributions during tax years 1984 through 1990, the period during which former A.R.S. § 43-1022(2) allowed a subtraction from Arizona gross income for contributions to most state and local employees' retirement plans. It would also have comprehended all similarly situated federal employees who paid Arizona income taxes on their mandatory contributions to federal retirement plans in tax years after 1990 under A.R.S. § 43-1001(2). The tax court denied certification of any such class. The plaintiff taxpayers cross-appealed from the denial of class certification.

In affirming the tax court's denial of class certification pertaining to tax years 1985 [11] through 1990, our prior opinion elected to follow the holding of *Arizona Department of Revenue v. Dougherty*, 198 Ariz. 1, 6 P.3d 306 (App.2000) ("*Ladewig I*") (review granted Jan. 9, 2001), that tax refunds may be sought through the filing of a class action in the tax court, but that membership in any taxpayer class is restricted to those who have exhausted applicable statutory administrative remedies before the ADOR and the Board of Tax Appeals. *Kerr IV*, 201 Ariz. at 133, ¶ 35, 32 P.3d at 416.

The day after we filed our prior opinion, the Arizona Supreme Court filed its opinion on review vacating *Ladewig I. Ariz. Dep't of Revenue v. Dougherty*, 200 Ariz. 515, 29 P.3d 862 (2001) ("*Ladewig II*"). *Ladewig II* agreed with this court's determination that a tax refund action may be brought as a class action, but found no legal or policy reason to restrict a tax refund plaintiff class to taxpayers who have actually resorted to and exhausted their administrative remedies. 200 Ariz. at 522, ¶ 24, 29 P.3d at 869. *Ladewig II*

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[11] See footnote 3, above.

held that an administrative refund claim may be filed on behalf of a taxpayer class, and that the filing of such a claim will toll the applicable statute of limitations for all other putative class members. 200 Ariz. at 522, ¶ 25, 29 P.3d at 869.

The legal theory on which the plaintiff taxpayers based their claim for refunds for tax years after 1990 was that taxation of their mandatory contributions to federal retirement plans pursuant to A.R.S. § 43-1001(2), without any statutory adjustment to equalize the treatment of federal employees as compared to state and local employees, violated the intergovernmental tax immunity doctrine codified as 4 U.S.C. § 111. Our prior opinion rejected this theory and thus determined that plaintiff taxpayers' cross-appeal was moot to the extent it challenged the tax court's orders denying their motion to certify a plaintiff class for tax years after 1990.

We have now reconsidered and reversed our prior determination of the intergovernmental tax immunity doctrine issue. The plaintiff taxpayers' bid for class certification for those tax years is not moot.

Our prior opinion also determined that the tax court had not abused its discretion in denying the plaintiff taxpayers' motion for class certification as to tax years 1985 through 1990. We determined:

> The trial court could reasonably have concluded that certification of a class of those whose refund claims had been denied would have not been "superior to other available methods for the fair and efficient adjudication of the controversy." Ariz. R. Civ. P. 23(b)(3). Each member of the prospective class would already have invoked the process contemplated by Arizona Individual Income Tax Ruling ITR 98-1 and would have been entitled to appeal the denial of their claims administratively and judicially. *See* A.R.S. §§ 42-1101, -1104,

-1106, -1118, -1119, -1122, -1251 through -1254 (1999 and Supp.2000). The trial court might understandably have been reluctant to overlay a second, redundant level of judicial supervision on the individual claims payment process that ADOR had already undertaken for tax years 1985 through 1990.

As we have mentioned, the putative class would also have encompassed refund 'claimants' who had filed no written refund claims with ADOR in any form. In *Arizona Department of Revenue v. Dougherty (Ladewig)*, 198 Ariz. 1, 6 P.3d 306 (App.2000), review granted January 9, 2001, this court held that a tax refund action may be brought and maintained as a class action, but that membership in the putative class is restricted to those taxpayers who have exhausted applicable statutory administrative remedies before the Department of Revenue and the Board of Tax Appeals. The Arizona Supreme Court's opinion on that issue will be controlling. We do not propose to revisit the issue while it is under advisement in that court. We elect instead to follow our own opinion in *Ladewig*.

. . . a person who files no refund claim of any description cannot be said to have complied with the exhaustion requirement no matter how loosely it may be interpreted. The trial court was within its discretion in declining to certify a class consisting of current or former federal employees seeking refunds for years between 1985 through 1990 for which they had failed to file any form of administrative refund claim.

201 Ariz. at 133, 32 P.3d at 416.

Ladewig II has vacated *Ladewig I*. In opposing reconsideration of our prior opinion in the instant case, ADOR argues that the tax court's determination to deny class certification may nevertheless be sustained on appeal on the

alternative grounds presented to it. These include ADOR's contention that the plaintiff taxpayers' representation of the putative class would not be adequate; that the plaintiff taxpayers' claims are not typical of those of the putative class; and that the putative class is not sufficiently numerous to render class certification appropriate. *See* Ariz. R. Civ. P. 23(a). We disagree.

The pre-*Ladewig II* uncertainty over the availability of administrative class claims in tax refund cases must necessarily have restricted the tax court's view of the potentially permissible scope of the taxpayer class and thereby affected its consideration of all the class certification criteria provided by Rule 23. *Ladewig II* has now eliminated that uncertainty. Because the question whether to certify a class under the Rule 23 criteria is committed to the tax court's sound discretion, *Godbey v. Roosevelt School District No. 66 of Maricopa County*, 131 Ariz. 13, 16, 638 P.2d 235, 238 (App.1981), we think it better to allow the tax court to have a fresh look at the plaintiff taxpayers' motion for class certification on remand.

C. ADOR Enforcement of Claim/Exhaustion Requirements

The plaintiff taxpayers contend that equal protection principles bar ADOR's argument that only persons who filed timely administrative claims may receive refunds. *Ladewig II* has mooted this contention. We need not address it.

IV. CONCLUSION

Arizona's income taxing scheme applicable to tax years 1991 to the present violates the intergovernmental tax immunity doctrine as codified in 4 U.S.C. § 111 to the extent it taxes federal employees' mandatory contributions to retirement plans, but not those of employees of state and local governmental units that have elected to "pick up" such contributions pursuant to 26 U.S.C. § 414(h). *Ladewig II* requires reconsideration of the plaintiff taxpayers' motion for

class certification in the tax court on remand. The judgment and orders on appeal are affirmed in part and reversed and remanded in part.

CONCURRING: WILLIAM F. GARBARINO, *Judge* and JOHN C. GEMMELL, *Judge*.

APPENDIX C

COURT OF APPEALS OF ARIZONA
DIVISION 1, DEPARTMENT T

No. 1 CA-TX 00-0023

CLARK R. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN and JOHN UDALL, individually and as representatives of the class comprised of federal employees who paid Arizona income taxes on federal retirement contributions during one or more of the years 1984 to date,

Plaintiffs-Appellees,
Cross-Appellants,

v.

MARK J. KILLIAN, in his capacity as Director of the Arizona Department of Revenue, the Arizona Department of Revenue of the State of Arizona,

Defendants-Appellants,
Cross-Appellees,

STATE OF ARIZONA, *ex rel.*,
the Arizona Department of Revenue,

Plaintiff-Appellant,
Cross-Appellee,

v.

CLARK J. KERR and BILLIE SUE KERR, husband and wife,

Defendants-Appellees,
Cross-Appellants,

CLARK J. KERR and BILLIE SUE KERR, husband and wife; and their Attorneys, BONN, LUSCHER, PADDEN & WILKINS, Chartered and O'NEIL, CANNON & HOLLMAN, S.C.,
Counterclaimants-Appellees, Cross-Appellants,

v.

STATE OF ARIZONA, *ex rel.*, the Arizona Department of Revenue,
Counterdefendant-Appellant, Cross-Appellee.

Aug. 28, 2001

OPINION

PATTERSON, *Judge.*

Under Arizona Revised Statutes (A.R.S.) § 43-1001(2) (1998 and Supp.2000), the Arizona gross incomes of state and local employees, like those of federal employees and all other Arizona individual income taxpayers, are deemed to be the same amounts that are calculated as their adjusted gross incomes for the purpose of federal income taxation. As permitted by 26 U.S.C. § 414(h)(2), Arizona has elected to "pick up" most state and local governmental employees' mandatory contributions to their retirement plans. Those contributions are therefore excluded from their federal adjusted gross (Arizona gross) incomes. A.R.S. § 43-1001(2). Congress, however, has not authorized the United States Government to "pick up" federal employees' mandatory contributions to their retirement plans. The effect of A.R.S. § 43-1001(2) on federal employees who reside in Arizona is to sweep all such contributions into their Arizona gross incomes.

Thus, for tax years from 1991 onward, Arizona law subjects to Arizona individual income taxation those portions of federal employees' compensation that they are required to contribute toward federal employee retirement plans, while leaving untaxed the corresponding mandatory contributions of most state employees to state employee retirement plans. This results in similarly situated and similarly earning taxpayers paying differing amounts. The superior court held that this statute, A.R.S. § 43-1001(2), violated the Public Salary Tax Act of 1939, 4 U.S.C. § 111.[1] The Arizona Department of Revenue and its director, Mark J. Killian (ADOR), appeal.

Plaintiffs Clark R. Kerr and Billie Sue Kerr, together with Plaintiffs Susan Moran, Steve Allen, and John Udall (the plaintiff taxpayers), cross- appeal from the superior court's orders denying certification of a plaintiff class consisting of all current or former federal employees who paid Arizona income taxes on mandatory contributions to federal retirement plans during one or more years from 1985 to the present, and of an alternative, smaller class consisting of all such federal employees who also filed timely refund claims with ADOR for one or more of the years 1991 to the present. The appeal and cross-appeal present these issues:

> 1. Whether Arizona's income taxing scheme violates 4 U.S.C. § 111 by taxing federal employees' mandatory

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[1] The pertinent text of 4 U.S.C. § 111 is:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

This legislation is effectively a codification of the constitutional intergovernmental tax immunity doctrine. *See Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 810-15, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989).

contributions to retirement plans, but not those of state employees;

2. Whether the superior court erred or abused its discretion in denying the plaintiffs' motions for class certification; and

3. Whether equal protection principles preclude ADOR from demanding compliance with an administrative claim requirement for taxpayers who initially paid the challenged taxes, while at the same time declining to pursue tax enforcement against other taxpayers who subtracted their mandatory federal retirement contributions on their Arizona returns and hence did not pay the challenged taxes.[2]

FACTS AND RELEVANT PROCEDURE

Until former A.R.S. § 43-1022(2) was amended in 1989, 1989 Ariz. Sess. Laws. Ch. 312, § 12, that statute subtracted from Arizona gross income:

> Contributions made to the state retirement system, the corrections officer retirement plan, the public safety per-

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[2] ADOR's opening brief also challenged the superior court's determination that the amended Arizona income tax return filed by Plaintiffs Clark R. Kerr and Billie Sue Kerr for tax year 1984 sufficiently specified a claim for refund of Arizona income taxes they paid on Plaintiff Clark Kerr's mandatory contributions to a federal employee retirement plan during that year. ADOR also challenged the court's decision to declare that the Kerrs' attorneys were entitled to an award of attorney's fees under the "common fund" theory. *See Kerr v. Killian*, 197 Ariz. 213, 218-20, 3 P.3d 1133, 1138-40 (App.2000). ADOR withdrew the common fund award challenge, however. The plaintiff taxpayers also informed us that ADOR had withdrawn its contention that the Kerrs did not sufficiently claim a refund for tax year 1984 and that the plaintiff taxpayers had agreed to limit their appeal from the denial of class certification to tax years 1985 to the present. We therefore do not address these contentions.

sonnel retirement system, the elected officials' retirement plan or a county or city retirement plan.[3]

Arizona law provided no corresponding subtraction for contributions made to federal employee retirement plans.

Since 1979, A.R.S. § 43-1001(2) has defined a resident individual's "Arizona gross income" as his or her federal adjusted gross income for the taxable year, computed under the Internal Revenue Code. *See* 1978 Ariz. Sess. Laws Ch. 213, § 2, eff. Jan. 1, 1979. Federal adjusted gross income is thus the starting point for determining an individual taxpayer's Arizona taxable income and ultimate income tax liability.

Effective in 1985, Arizona enacted provisions authorized by 26 U.S.C. § 414(h)[4] that permitted state and local govern-

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[3] The 1989 amendment eliminated the subtraction for contributions to the state retirement system, and county and city retirement plans. A later amendment, 1991 Ariz. Sess. Laws Ch. 155, § 8, eliminated the remaining subtractions. For tax years 1984 through 1986, A.R.S. § 43-1022(2) also permitted subtraction of contributions to the judges' retirement fund. Effective July 1, 1986, that subtraction was repealed and the subtraction for contributions to the corrections officers' retirement fund was added in its place. *See* 1986 Ariz. Sess. Laws Ch. 325, § 3, 5.

[4] Section 414(h) provides:

> Tax treatment of certain contributions
>
> (1) In general
>
> Effective with respect to taxable years beginning after December 31, 1973, for purposes of this title, any amount contributed—(A) to an employees' trust described in section 401(a), or (B) under a plan described in section 403(a), shall not be treated as having been made by the employer if it is designated as an employee contribution.
>
> (2) Designation of units of government
>
> For purposes of paragraph (1), in the case of any plan established by the government of any State or political subdivision

mental employers to "pick up" mandatory contributions that their employees would otherwise have made. This enabled those state employees to exclude the amounts of their retirement plan contributions from their federal gross income. Congress has not chosen to make this benefit available to federal employees.

Consequently, under A.R.S. § 43-1001(2), the Arizona gross incomes of federal employees include all sums they are required to contribute to their respective retirement plans, while the Arizona gross incomes of state and local employees whose employing units "pick up" their required contributions to retirement plans necessarily exclude the amount of those contributions.[5] *See Kerr v. Waddell*, 183 Ariz. 1, 12-13, 899 P.2d 162, 173-74 (App.1994) (*Kerr I*), *vacated on other grounds*, 185 Ariz. 457, 916 P.2d 1173 (App.1996) (*Kerr II*).

In *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), the Supreme Court invalidated certain Michigan income taxing provisions that taxed retirement benefits paid by the United States Government while exempting retirement benefits paid by state and local governmental entities. The Court determined that the Michigan taxing scheme violated 4 U.S.C. § 111. The Court later held that *Davis* was to be applied

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thereof, or by any agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

[5] The fund managers of the Public Safety Personnel Retirement System and the Corrections Officer Retirement Plan have the power to authorize state and local employers to "pick up" the retirement contributions of members of those plans. A.R.S. § § 38-843.01 through 38-843.04 (Supp.2000) and 38-891 (1996). As of 1999, neither fund manager had done so.

retroactively. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993).

In 1989, the plaintiff taxpayers brought an earlier action, Tax Court Cause No. 89-01153, challenging the differential taxation of A.R.S. § 43-1001(2) and former A.R.S. § 43-1022(2). In *Kerr I* this court held that their state-law claims for refunds were barred by their failure to exhaust their administrative remedies before bringing the action, but that their claims for declaratory and injunctive relief under 42 U.S.C. § 1984 could proceed. *Kerr I* held that former sections 43-1022(2) and 43-1001(2), as applied to state and federal employees, violated 4 U.S.C. § 111. 183 Ariz. at 14-17, 899 P.2d at 175-78.

On petition for review our supreme court remanded for further consideration in light of *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995). On remand this court held that Arizona's administrative process for challenging the denial of tax refunds provided an adequate state remedy within *National Private Truck Council*, and that the plaintiffs' claims under 42 U.S.C. § 1984 were barred because plaintiffs failed to resort to and exhaust those remedies. *Kerr II*, 185 Ariz. at 464-67, 916 P.2d at 1180-83. We remanded the action to the tax court with directions to dismiss it in its entirety. *Id.*

Simultaneously with the filing of their 1989 action in the tax court, the plaintiff taxpayers filed corresponding administrative refund claims with ADOR. In 1993, a hearing officer for ADOR determined that ADOR had no authority to rule on the legality of A.R.S. § 43-1001(2) and former A.R.S. § 43-1022(2) or to recognize a class refund claim. *Kerr v. Killian*, 197 Ariz. 213, 3 P.3d 1133 (App.2000) (*Kerr III*). In 1994, during the pendency of *Kerr I* in this court, the Arizona Board

of Tax Appeals heard the plaintiff taxpayers' administrative appeal from the ADOR hearing officer's adverse ruling. The matter remained under advisement with the Board until 1997, the year following the dismissal of the plaintiff taxpayers' first action pursuant to *Kerr II*. *Kerr III*, 197 Ariz. at 215-16, 3 P.3d at 1135-36. The Board ruled that the plaintiff taxpayers were entitled to refunds for 1985 through 1990 because former A.R.S. § 1022(2) violated the intergovernmental tax immunity doctrine codified in 4 U.S.C. § 111. The Board also held that A.R.S. § 43-1001(2) did not violate that doctrine and that no refunds for tax years after 1990 would be awarded. The Board also agreed with the ADOR hearing officer that neither ADOR nor the Board could entertain a class refund claim.

The plaintiff taxpayers and ADOR commenced the instant actions in April and May 1997 to appeal the Board's ruling. In mid-1997, the Governor of Arizona directed ADOR "to make refunds for the tax years 1985 through 1990 to all taxpayers who had filed timely refund claims, whether they were parties to the administrative action or not." *Kerr III*, 197 Ariz. at 216, 3 P.3d at 1136. In June 1998 the tax court entered a judgment awarding the plaintiffs' attorneys an award of 20% of each such refund for fees under the common fund doctrine. We affirmed that judgment. *Kerr III*, 197 Ariz. 213, 3 P.3d 1133.

During the pendency of the appeal in *Kerr III*, the superior court denied plaintiff taxpayers' motion to certify a class consisting of all current and former federal employees who paid Arizona income taxes on contributions they made to United States Government retirement plans from 1984 to the present who have not received refunds of such taxes. Following the analysis of our opinion in *Kerr I*, vacated in *Kerr II*, the court later held that the application of A.R.S. § 43-1001(2) violated 4 U.S.C. § 111 to the extent it caused discriminatory state taxation of federal employees as

compared to state and local governmental employees. Finally, the court denied the plaintiff taxpayers' alternative motion to certify a class of all federal employees who filed timely refund claims for one or more years from 1991 to the present.

From judgment entered in accordance with the superior court's rulings, ADOR appeals and the plaintiff taxpayers cross-appeal.

ANALYSIS

A. Differential Taxation of Retirement Plan Contributions

1. Standard of Review

On appeal from summary judgment, the trial court's rulings on questions of law are reviewed *de novo*. *United Bank of Ariz. v. Allyn*, 167 Ariz. 191, 195, 805 P.2d 1012, 1016 (App.1990).

2. A.R.S. § 43-1001(2) and 4 U.S.C. § 111

As calculated for tax purposes in Arizona, the amount on which taxes are paid is the adjusted gross income for federal taxation purposes. According to A.R.S. § 43-1001(2), the gross incomes of state and local employees, like those of federal employees and all other Arizona taxpayers, constitutes this amount. Further, Arizona's individual income tax statutes contain no provision that adds back the sums representing state and local government employees' mandatory retirement contributions in the process of calculating their Arizona taxable incomes. They also contain no provision that subtracts the sums representing federal employees' mandatory retirement contributions in that process. The net result is that federal employees pay Arizona income taxes on the amounts representing their mandatory retirement contributions, while some state and local governmental employees do not.

In *Kerr I* we determined that the Arizona income taxing scheme thereby violated 4 U.S.C. § 111. We stated:

> Both the tax court and the defendants err in relying upon "the source of the pay or compensation" to extricate Arizona's scheme for taxation of federal, state, and local retirement contributions from the prohibited category of discrimination. The thrust of defendants' reasoning is found in their statement that "[t]he only obstacle to the exclusion of federal plan contributions [from Arizona income taxation] is the federal employer, who has refrained from acting to 'pick up' contributions." Their implicit major premise, which is incorrect, is that Arizona was helpless other than to adopt federal adjusted gross income without modification as part of the state income tax scheme.
>
> Contrary to the tax court's ruling and appellees' reasoning, it was ultimately Arizona legislative action that imposed the discriminatory tax scheme. In other words, it was not federal legislative action, but state legislative action that caused state and local retirement contributions to be exempted from Arizona income taxation while federal retirement contributions were not. No provision of law to which we are cited required Arizona to adopt federal adjusted gross income in determining Arizona taxable income.

183 Ariz. at 14-15, 899 P.2d at 176-77.

The reasoning of *Kerr I* is incomplete and ultimately incorrect. As we have observed, 4 U.S.C. § 111 consents to state and local taxation of federal employees' pay or compensation as long as "the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." The *Kerr I* court focused on whether the differing Arizona tax treatment of state and local governmental employees as compared to that of federal

employees actually resulted from the operation of Arizona income tax statutes. *Kerr I* accordingly never directly addressed the more fundamental question whether the differential Arizona tax treatment was actually "based on" the federal or state source of the pay or compensation.

The seminal modern decision under 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine is *Davis*. 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891. In *Davis*, a Michigan statute expressly excluded from state taxable income all retirement benefits received from the state and its political subdivisions, but included most other forms of retirement benefits. The Court stated: "The effect of this definition is that the retirement benefits of retired state employees are exempt from state taxation while the benefits received by retired federal employees are not." 489 U.S. at 806, 109 S.Ct. 1500.

In *Jefferson County v. Acker*, 527 U.S. 423, 119 S.Ct. 2069, 144 L.Ed.2d 408 (1999), the Supreme Court demonstrated its approach to identifying circumstances in which, unlike the situation in *Davis*, 4 U.S.C. § 111 is simply inapplicable. In *Jefferson County*, two federal judges who held court in Jefferson County, Alabama, challenged a county "license tax" on persons who engaged in business activities that were not subject to any other license or privilege tax under Alabama law. The judges' theory was that as applied to them, the county tax directly burdened the federal government or its instrumentalities in violation of the intergovernmental tax immunity doctrine. The Supreme Court disagreed and held that the tax operated as a nondiscriminatory tax on employee compensation and was permissible under that doctrine as codified in 4 U.S.C. § 111. The Court explained:

> In *Davis*, the Court held that a state tax exempting retirement benefits paid by the State but not those paid by the Federal Government violated the Public Salary

> Tax Act's nondiscrimination requirement. *See* 489 U.S.,[sic] at 817-818 [109 S.Ct. 1500]. Jefferson County's tax, by contrast, does not discriminate against federal judges in particular, or federal officeholders in general, based on the federal *source* of their pay or compensation. The tax is paid by all State District and Circuit Court judges in Jefferson County and the three State Supreme Court justices who have satellite offices in the county.

527 U.S. at 442-43, 119 S.Ct. 2069.

From *Davis* and *Jefferson County*, we derive the principle that a state income taxing scheme may be said to discriminate between federal employees and state or local employees "because of the source of [their] pay or compensation" if it gives state or local employees an income tax advantage over federal employees, regardless of whether other state or local taxpayers are in the same position as federal employees, or the state taxing scheme imposes an income tax disadvantage on federal employees but not on state or local employees, regardless of whether other state or local taxpayers are in the same position as state or local employees. The discrimination found in *Davis*, and also that which resulted from the application of former A.R.S. § 43-1022(2) in this case, is of the first variety—in both situations the state taxing scheme conferred a tax benefit exclusively on some state and local employees to the exclusion of federal employees and all other state and local taxpayers.

The plaintiff taxpayers in this case seek to analogize the second variety of discrimination to A.R.S. § 43-1001(2). Their attempt fails. Section 43-1001(2) disadvantages *all* Arizona resident individual taxpayers, private or governmental, who make mandatory retirement plan contributions that are not "picked up" or paid directly by their employers, over *all* Arizona resident individual taxpayers whose private or governmental employers pick up or directly pay their

mandatory retirement contributions. Either of these groups may contain both state or local government employees and federal employees. The Arizona taxing scheme does not single out all or any subgroup of state or local governmental employees for advantageous treatment as against all others. It likewise does not single out all or any subgroup of federal employees for disadvantageous treatment as against all others. Under those circumstances, despite the fact that some state and local employees are taxed more favorably than federal employees and other Arizona income taxpayers by virtue of A.R.S. § 43-1001(2), we conclude as a matter of law that Arizona law does not discriminate against the plaintiff taxpayers or their putative class "because of the source of [their] pay or compensation" in violation of 4 U.S.C. § 111.

The Supreme Judicial Court of Massachusetts similarly analyzed an analogous situation in *Cooper v. Commissioner of Revenue*, 421 Mass. 557, 658 N.E.2d 963 (1995). In that case a Massachusetts statute exempted from state taxation all retirement benefits paid by annuity, pension, endowment, or retirement plans of the United States government or the state or governmental employers to which the recipient employee had contributed. Under this statute, state, local, or federal employees who had not contributed a portion of their salary to their retirement funds were required to pay state income taxes on their retirement benefits.

The plaintiff taxpayers in *Cooper* were military retirees whose retirement plan was funded entirely by the federal government. They claimed refunds of Massachusetts income taxes that they paid on their military retirement benefits. The Appellate Tax Board dismissed their claims.

The Supreme Judicial Court affirmed. The court reasoned:

> Massachusetts tax law distinguishes between contributory and noncontributory retirement plans, not between State and Federal retirees. "The determining factor for

> the Massachusetts exemption is whether the retirement fund is a 'contributory fund to which the employee has contributed.' "Technical Information Release (TIR) 89-6 (May 10, 1989), 2 Official MassTax Guide at 369 (West 1995). "Any Federal retirement income is exempt from Massachusetts tax if the system is contributory and the employee actually contributed," *id.*, and, on the other hand, "[a] non-contributory government pension, received by a retired employee of [a political subdivision of the Commonwealth] . . . is includable in the Massachusetts gross income of the employee . . . in the taxable year in which the pension is paid." Letter Ruling 81-51 (June 11, 1981), *supra* at 576. In sum, the statutory provisions treat retirement benefits paid by the Commonwealth and the Federal government in precisely the same way.

658 N.E.2d at 964.

Arizona's taxing scheme similarly distinguishes not between state and federal employees, but rather between all those whose employers make or pick up their mandatory retirement contributions and all those whose employers do not. The Arizona taxing scheme, like that of Massachusetts, does not discriminate "because of the [federal or state] source of the pay or compensation." *Cf. Witte v. Director of Revenue*, 829 S.W.2d 436, 439 n. 4 (Mo.1992) (rejecting analogous challenge to non-deductibility of federal civil service retirement system contributions, stating: "The appellants have not shown the existence of a line of demarcation between those who benefit from § 143.141 [allowing state deduction of FICA, railroad retirement, and self-employment taxes paid to federal government] and those who do not, based on a classification scheme that is, indeed, 'intergovernmental.'").

The plaintiff taxpayers cite *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S.Ct. 692, 74 L.Ed.2d 562 (1983), for the proposition that federal law does not permit "piggybacking" to excuse discriminatory state taxation. They are mistaken in believing that *Memphis Bank & Trust* supports their position in this case. That case involved a state income tax system that adopted federal adjusted gross income as state gross income but made no provision for excluding interest on federal notes and bonds from state taxation. Because interest income from state and local notes and bonds is excluded from federal gross income, it never became a part of the state gross income. The Court found that the state system violated the intergovernmental tax immunity doctrine because it discriminated between holders of state and federal obligations "by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations." 459 U.S. at 398, 103 S.Ct. 692.

The beneficiaries of the state taxing scheme challenged in *Memphis Bank & Trust* were defined by no broader principle or characteristic than their status as holders of state and local obligations. Here, in contrast, the beneficiaries of the challenged Arizona taxing scheme are all those persons whose employers, whether state, local, federal, or private, either make or pick up their employees' mandatory retirement plan contributions. Similarly, the persons who are disadvantaged by the challenged Arizona taxing scheme are all those whose employers, again whether state, local, federal, or private, choose to leave to their employees the obligation to make their own mandatory retirement plan contributions with after-tax dollars.

The superior court erred in determining that A.R.S. § 43-1001(2) and the Arizona resident individual income taxing scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine as applied to the plaintiff taxpayers.

B. Denial of Class Certification

The plaintiff taxpayers cross-appeal from the denial of their motions to certify two alternative plaintiff classes. The sole legal theory on which the plaintiff taxpayers based their claim for refunds for tax years after 1990 was that taxation of their mandatory contributions to federal retirement plans by dint of A.R.S. § 43-1001(2) violated the intergovernmental tax immunity doctrine codified as 4 U.S.C. § 111. We have rejected this theory. The plaintiff taxpayers' appeal is thus moot to the extent it challenges the tax court's orders denying their motions to certify plaintiff classes for tax years 1991 through the present. *See McNutt v. Dep't of Revenue*, 196 Ariz. 255, 268, ¶ 51, 995 P.2d 691, 704 (App.1998). We accordingly consider the plaintiff taxpayers' appeal from the denial of class certification only to the extent it pertains to tax years 1985 through 1990.

1. Standard of Review

We review the trial court's ruling on a motion for class certification for abuse of discretion. *Godbey v. Roosevelt Sch. Dist. No. 66 of Maricopa County*, 131 Ariz. 13, 16, 638 P.2d 235, 238 (App.1981); *Markiewicz v. Sa[illegible] River Valley Water Users' Ass'n*, 118 Ariz. 329, 341, 576 P.2d 517, 529 (App.1978).

2. The Trial Court's Order

In June 1997, two months after the plaintiff taxpayers commenced this litigation, the Governor of Arizona directed ADOR to make refunds for tax years 1985 through 1990 to all taxpayers who had filed timely refund claims, whether or not they had been parties to any administrative proceedings on those claims. *Kerr III*, 197 Ariz. at 216, ¶ 8, 3 P.3d at 1136. It is undisputed that ADOR took action to implement that order, though disputes arose concerning ADOR's refunding decisions in particular claimants' cases.

The plaintiff taxpayers later moved unsuccessfully to certify a class consisting of all current and former federal employees who paid Arizona income taxes on contributions they made to United States Government retirement plans from 1984 to the present who had not been paid refunds of such taxes. The relevant class would have encompassed all current or former federal employees who paid Arizona income taxes on their mandatory contributions to federal retirement plans and either (1) filed a refund claim that ADOR denied, or (2) filed no refund claim at all. The plaintiff taxpayers fail to convince us that the trial court abused its discretion by denying that motion as to tax years 1985 through 1990.

The trial court could reasonably have concluded that certification of a class of those whose refund claims had been denied would have not been "superior to other available methods for the fair and efficient adjudication of the controversy." Ariz. R. Civ. P. 23(b)(3). Each member of the prospective class would already have invoked the process contemplated by Arizona Individual Income Tax Ruling ITR 98-1 and would have been entitled to appeal the denial of their claims administratively and judicially. *See* A.R.S. §§ 42-1101, -1104, -1106, -1118, -1119, -1122, -1251 through -1254 (1999 and Supp.2000). The trial court might understandably have been reluctant to overlay a second, redundant level of judicial supervision on the individual claims payment process that ADOR had already undertaken for tax years 1985 through 1990.

As we have mentioned, the putative class would also have encompassed refund 'claimants' who had filed no written refund claims with ADOR in any form. In *Arizona Department of Revenue v. Dougherty* (*Ladewig*), 198 Ariz. 1, 6 P.3d 306 (App.2000), review granted January 9, 2001, this court held that a tax refund action may be brought and maintained as a class action, but that membership in the

putative class is restricted to those taxpayers who have exhausted applicable statutory administrative remedies before the Department of Revenue and the Board of Tax Appeals. The Arizona Supreme Court's opinion on that issue will be controlling. We do not propose to revisit the issue while it is under advisement in that court. We elect instead to follow our own opinion in *Ladewig*.

We assume *arguendo* that ADOR would be estopped to deny that the bare filing of amended income tax returns, refund claims, or protective claims as contemplated by ADOR Arizona Individual Income Tax Ruling ITR 98-1 constituted sufficient exhaustion of administrative remedies within the contemplation of the court in *Ladewig See Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 575-79, ¶¶ 29-41, 959 P.2d 1256, 1266- 70 (1998) (ADOR may be subjected to equitable estoppel under limited circumstances). However, a person who files no refund claim of any description cannot be said to have complied with the exhaustion requirement no matter how loosely it may be interpreted. The trial court was within its discretion in declining to certify a class consisting of current or former federal employees seeking refunds for years between 1985 through 1990 for which they had failed to file any form of administrative refund claim.

Because of our analysis, we need not address the question of adequacy of the plaintiff taxpayers' representation of the putative class, the typicality of the plaintiff taxpayers' claims as compared to those of the putative class members, or the numerosity of the putative class. *See* Ariz. R. Civ. P. 23(a). We decline to consider the plaintiff taxpayers' contention, made for the first time in its Reply Brief on Cross-Appeal, that the orders denying class certification must be reversed because the superior court failed to make sufficiently specific findings under Rule 23.

C. ADOR Enforcement of Claim/Exhaustion Requirements

Finally, we consider the plaintiff taxpayers' contention that equal protection principles bar ADOR's argument that only persons who filed timely administrative claims may receive refunds. They point out that in 1998 ADOR's Enforcement Division stated in writing that it would abate and refrain from enforcing any unpaid assessments of Arizona individual income taxes attributable to federal retirement contributions made from 1984 through 1990, and that such an abatement was granted in at least one case. Citing *Gosnell Development Corp. v. Arizona Department of Revenue*, 154 Ariz. 539, 541, 744 P.2d 451, 453 (App.1987), and *Smith v. State*, 349 N.C. 332, 507 S.E.2d 28 (1998), the plaintiff taxpayers argue that "DOR's refusal to provide refunds to those who paid the illegal tax but did not file a claim form, while simultaneously giving the full benefit of *Davis* and *Kerr I* to those who did not pay in the first place (and so obviously filed no claim form)," contravened equal protection principles.

We disagree. Unlike the situation in *Gosnell* and *Smith*, the persons to whom the plaintiff taxpayers contend relief was unfairly granted were not in the same position as those taxpayers who filed no administrative claims. In *Gosnell*, the plaintiff's competitors had mistakenly calculated and paid contracting taxes on a tax base that excluded non-deductible sums, while the plaintiff had made no such exclusions and paid the correct amounts. ADOR adopted a policy that upon any future audit of the competitors, no deficiency assessments would be made, but at the same time declined to grant any refund to the plaintiff. Similarly, in *Smith* the taxing authority had made refunds of illegal taxes to some but not all taxpayers who had failed to file notices of refund claims. In contrast, all taxpayers here against whom ADOR determined not to enforce deficiency assessments had previously filed individual returns that affirmatively claimed deductions for

sums contributed to mandatory federal retirement plans. Those returns did not differ in substance from the administrative claims filed by those who had initially paid the disputed taxes. The taxpayers whose deficiency assessments ADOR abated were not situated similarly to taxpayers who filed no administrative refund claims at all. No violation of equal protection rights appears.

CONCLUSION

Arizona's income taxing scheme applicable to tax years 1991 to the present does not violate 4 U.S.C. § 111 to the extent it taxes federal employees' mandatory contributions to retirement plans, but not those of certain state and local employees. The trial court did not err or abuse its discretion in denying the plaintiff taxpayers' motions for class certification. Equal protection principles do not bar ADOR from denying refunds for tax years 1985 through 1990 to those who filed no administrative refund claims at all for those years, while abating past deficiency assessments against taxpayers who deducted their federal retirement contributions for the same years and calculated their taxes accordingly.

The judgment and orders on appeal are affirmed in part and reversed in part, and the matter is remanded with directions to enter judgment in accordance with the views expressed in this opinion.

CONCURRING: REBECCA WHITE BERCH, *Judge*, NOEL FIDEL, *Judge*.

APPENDIX D

IN THE SUPERIOR COURT OF THE
STATE OF ARIZONA
IN AND FORTHE COUNTY OF MARICOPA

No. TX 97-00119
No. TX 97-00131
No. TX 97-00150
(Consolidated)

CLARK J. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN and JOHN UDALL, individually and as representatives of the class comprised of federal employees who paid Arizona income taxes on federal retirement contributions during one or more of the years 1984 to date,

Plaintiffs,

v.

MARK J. KILLIAN, in his capacity as Director of the Arizona Department of Revenue, the ARIZONA DEPARTMENT OF REVENUE of the state of Arizona,

Defendants.

STATE OF ARIZONA, *ex rel.*,
the ARIZONA DEPARTMENT OF REVENUE,

Plaintiffs,

v.

CLARK J. KERR and BILLIE SUE KERR, husband and wife,

Defendants.

CLARK J. KERR and BILLIE SUE KERR, husband and wife; AND THEIR ATTORNEYS, BONN LUSCHER, PADDEN & WILKENS, CHARTERED and O'NEIL, CANNON & HOLLMAN, S.C.,

Counterclaimants,

v.

STATE OF ARIZONA, *ex rel.*,
the ARIZONA DEPARTMENT OF REVENUE,
Counterdefendants.

JUDGMENT

(Assigned to the Honorable Susan R. Bolton)

The court having considered the various motions filed by the parties, having heard oral argument, being fully advised in the premises, having determined that there is no just reason to delay the entry of judgement and good cause appearing therefore:

IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. Defendants' Motion for Partial Summary Judgment Re: The Validity of 1984 Claim, filed April 17, 1998, is denied.

2. The Kerrs' Cross-Motion for Partial Summary Judgment Re: Balance of 1984 Refunds, Filed May 29, 1998, is granted.

3. Plaintiffs' Motion for Class Certification, filed May 1, 1998, is denied.

4. Plaintiffs' Motion for Reconsideration of Class Certification in Light of Newly Discovered Evidence, Filed August 26, 1998, is denied.

5. Defendants' Motion for Summary Judgment Re: Refunds for Years 1991 and After, filed November 12, 1999, is denied.

6. Plaintiffs' Cross-Motion for Partial Summary Judgment Re: Refunds for Years 1991 and After, filed December 13, 1999, is granted.

7. Plaintiffs'/Counterclaimants' Motion for a Common Fund Attorneys' Fee Award filed May 18, 2000, is granted. Plaintiffs' counsel are entitled to a common fund fee award as to all refunds for years 1991 and after for similarly situated taxpayers, not just as to refunds awarded to the named Plaintiffs.

8. Plaintiffs Motion for Class Certification of the Class Consisting of All Present and Former Federal Employees who have Filed a Timely Claim with the Arizona Department of Revenue for a Refund of Taxes Paid on Mandatory Federal Retirement Contributions for one or more Years from 1991 to Present filed June 13, 2000, which the Court deems to be a Motion for Reconsideration, is denied.

9. The Court, having found there is no just reason for delay, expressly directs that this Judgment be entered at this time as a final Judgment pursuant to Rule 54(b), *Ariz. R. Civ.P.*

DONE IN OPEN COURT this 17th. day of August, 2000.

/s/ SUSAN R. BOLTON
Honorable SUSAN R. BOLTON
Judge of the Superior Court

APPROVED AS TO FORM

BONN & WILKENS, CHARTERED

By: /s/ D. Michael Hall — Dated: 8/16/00
PAUL V. BONN
RANDALL D. WILKENS
D. MICHAEL HALL
805 North Second Street
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JANET NAPOLITANO
By: /s/ PATRICK IRVINE ESQ.
PATRICK IRVINE ESQ.
Assistant Attorney General
Civil Division, Tax Section
1275 West Washington
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(006534)

Dated: 8/ 16/ 2000

APPENDIX E

COURT of APPEALS of ARIZONA
DIVISION 1, DEPARTMENT T

No. 1 CA-TX 98-0014

CLARK J. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN and JOHN UDALL, individually and as representatives of the class comprised of federal employees who paid ARIZONA income taxes on FEDERAL RETIREMENT CONTRIBUTIONS during one or more of the years 1984 to date,

Plaintiffs-Appellees,

v.

MARK J. KILLIAN, in his capacity as DIRECTOR OF THE ARIZONA DEPARTMENT OF REVENUE, THE ARIZONA DEPARTMENT OF REVENUE OF THE STATE OF ARIZONA,

Defendants-Appellants.

STATE OF ARIZONA,
ex rel., THE ARIZONA DEPARTMENT OF REVENUE,

Plaintiffs-Appellants,

v.

CLARK J. KERR and BILLIE SUE KERR, husband and wife,

Defendants-Appellees.

CLARK J. KERR and BILLIE SUE KERR, husband and wife; and their attorneys, BONN, LUSCHER, PADDEN & WILKINS, CHARTERED and O'NEIL, CANNON & HOLLMAN, S.C.,
Counterclaimants-Appellees,

v.

STATE OF ARIZONA, *ex rel.*,
THE ARIZONA DEPARTMENT OF REVENUE,
Counterdefendants-Appellants.

Jan. 27, 2000.

As Amended April 13, 2000.
Review Denied Dec. 5, 2000.

OPINION

KLEINSCHMIDT, *Judge.*

This is an appeal by the Arizona Department of Revenue from an award of fees to attorneys who successfully represented taxpayers on a refund claim. We affirm.

Before 1991, Arizona exempted from state income tax the amount of money state and local government employees paid into retirement plans. In *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), the United States Supreme Court invalidated a similar tax provision because no exemption was afforded federal employees. The court ruled that the exemption was not in accord with the Intergovernmental Tax Immunity Doctrine codified in 4 U.S.C. section 111.

In November 1989 the five taxpayers, who are or were federal employees and who are the appellees in this case, sued the Arizona Department of Revenue in the tax court in a

case styled *Kerr v. Waddell*. They brought the action on behalf of themselves and all similarly situated persons, and they sought a declaration that the Arizona tax scheme violated the federal statute, and asked for injunctive relief, damages, and refunds. While the action was pending, the tax court directed the Department to include a notice in its tax instruction booklets about the pendency of the litigation, as well as a form that current and former federal employees could file to preserve any right to refunds that might be due them if the taxpayers prevailed. This was done in the 1990 instruction booklets and in instruction booklets from 1994 through 1998. The tax court later declared the Department's refusal to exempt contributions to federal retirement plans invalid, but declined other relief.

The decision was appealed, and in *Kerr v. Waddell*, 183 Ariz. 1, 899 P.2d 162 (App.1994) ("Kerr I") we held that the taxpayers' failure to invoke their administrative remedies before the Department and the State Board of Tax Appeals had deprived the tax court of jurisdiction over their state law claims for declaratory relief and refunds. We also held that the failure to invoke administrative remedies did not affect the viability of the taxpayers' claims for declaratory and injunctive relief and damages under 42 U.S.C. section 1983. We further held that the exemption scheme violated 4 U.S.C. section 111.

On review, the Arizona Supreme Court returned the case to us for reconsideration in light of the intervening decision in *National Private Truck Council v. Oklahoma Tax Com'n.*, 515 U.S. 582, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995). On reconsideration we vacated *Kerr I* and held that the taxpayers' failure to invoke their administrative remedies foreclosed the tax court from affording them any relief. We remanded to the tax court with directions to dismiss the action in its entirety. *See Kerr v. Waddell*, 185 Ariz. 457, 916 P.2d 1173 (App.1996) ("Kerr II").

When the taxpayers filed their lawsuit they also filed administrative claims with the Department on behalf of themselves and the putative class requesting refunds on the same grounds asserted in the cases they filed in the tax court in *Kerr v. Waddell*. In 1993, a hearing officer for the Department held that the Department had no legal authority to pass on the legality of the statutory scheme or to recognize a class refund claim.

The taxpayers appealed the hearing officer's ruling. The Board of Tax Appeals heard the matter in 1994 and ruled on it in 1997, holding that neither the Department nor the Board could entertain a class refund claim. It also held that the taxpayers who were parties to the administrative proceeding were entitled to refunds for 1985 through 1990.

The taxpayers then began this action in the tax court to appeal the Board's ruling. Two months later, the Governor of Arizona directed the Department to make refunds for the tax years 1985 through 1990 to all taxpayers who had filed timely refund claims, whether they were parties to the administrative action or not.

The taxpayers asked that their attorneys be awarded 20% of the total refunds that the Department had paid and would pay pursuant to the governor's direction. Over the Department's opposition, the court ruled that the common fund doctrine applied and that the taxpayers' attorneys were entitled to an award of reasonable fees. This was subsequently confirmed at 20% of the refunds. The fee will be approximately $3.2 million which includes costs and expenses. The Department brought this appeal.

THE DEPARTMENT IS AGGRIEVED BY THE JUDGMENT

The taxpayers argue that this appeal should be dismissed on the grounds that the Department is not aggrieved by the fee award. A party is "aggrieved" by a judgment if it denies that party some personal or property right or imposes on that party some substantial burden or obligation. *See Matter of Gubser*, 126 Ariz. 303, 306, 614 P.2d 845, 848 (1980). The denial or imposition must flow directly from the judgment, and not merely from applying the legal principle established in the judgment to another proceeding. *See In re Roseman's Estate*, 68 Ariz. 198, 200, 203 P.2d 867, 868 (1949).

Aggrievement by all or part of a judgment does not remove all limitations on the scope of a party's appeal. A party who is aggrieved by a judgment may nevertheless lack standing to assert particular arguments in attempting to secure a reversal of a judgment. *See Goglia v. Bodnar*, 156 Ariz. 12, 18, 749 P.2d 921, 927 (App.1987). Lack of aggrievement is a jurisdictional defect, but lack of standing to urge a particular argument is not. *See Matter of Strobel*, 149 Ariz. 213, 216, 717 P.2d 892, 895 (1986). Since Arizona has no analog to the "case or controversy" provision in its constitution, our reluctance to consider issues raised where there is no standing is a rule of judicial restraint. *See State v. B Bar Enterprises, Inc.*, 133 Ariz. 99, 101 n. 2, 649 P.2d 978, 980 n. 2 (1982).

After this appeal was filed, the taxpayers moved to dismiss it on the grounds that the Department was not an aggrieved party. Another panel of this court considered the motion and denied it, concluding that the taxpayers had failed to show that the Department was not aggrieved but had shown at most that the Department might not have standing to make one or more of the arguments included in the opening brief.

The taxpayers now contend that the only way in which the Department could possibly be aggrieved is because it will be

required to pay from its own funds 20% of the 26 refunds that it paid in full before the court ordered it to withhold 20% of each refund. They go on to argue that because the Department did not address the issue of these 26 refunds in its opening brief, it has waived that issue on appeal and with that waiver, the Department's aggrieved status evaporates.

The problem with the taxpayers' argument is that the issue was not waived. While the Department did not refer to the 26 refunds in its opening brief, it did raise them as a response to a motion to dismiss which was filed by the taxpayers. The Department prevailed on that motion. If that were not enough, the question whether the Department must pay the fees as to the 26 refunds is subsumed in the Department's general attack on the applicability of the common fund doctrine to tax refund cases. In other words, if the Department were to prevail on its argument that the common fund doctrine does not apply in this case, it would not have to pay the fees for the 26 refunds.

We believe that the Department has carried its burden of demonstrating that it is aggrieved by the judgment. First, there is the matter of having to pay 20% of 26 refunds out of the Department's own funds. Then, as the Department pointed out in its response to the motion to dismiss, the judgment required it to undertake multiple mailings that cost between $10,000 and $15,000 more than it would have otherwise had to pay. Finally, the Department must undertake the administrative task of withholding part of each refund and periodically accounting for and remitting the amounts withheld to the taxpayer's counsel.

THE DEPARTMENT DOES NOT HAVE STANDING TO ASSERT THE DUE PROCESS RIGHTS OF THE NON-PARTY TAXPAYERS

The Department challenges the award on the theory that the procedure used to arrive at the award violated the process

of law due non-party taxpayers because those taxpayers did not receive adequate notice that a common fund award would be sought. The Department lacks standing to seek reversal on the basis of this argument because the right to due process asserted does not belong to the Department. As we noted in *State v. B Bar Enterprises, Inc.*, 133 Ariz. at 101 n. 2, 649 P.2d at 980 n. 2, a litigant may be accorded standing to assert the constitutional rights of a third person only if the litigant has a substantial relationship to the third person, the third person is unable to assert the constitutional rights on his or her own behalf, and failing to grant the litigant standing would dilute the third person's constitutional rights. None of these requirements is met here. The Department's attempt to assume a protective role as to non-party taxpayers can hardly be characterized as the manifestation of a substantial relationship in view of the Department's unceasing efforts over the last nine years to deny these taxpayers any refunds at all. Moreover, the non-party taxpayers were able to assert their own rights. After the tax court ruled that the common fund rule applied, it ordered that notice of the hearing to determine the percentage of fees to be awarded be given to all of the taxpayers entitled to a refund. This was done. The court received communication from some of the non-party taxpayers on the common fund issue, and at the hearing on what percentage should be paid, several non-party taxpayers appeared and addressed the court. We agree with the trial court that notice was adequate.

THE DEPARTMENT IS NOT COLLATERALLY ESTOPPED TO CHALLENGE A COMMON FUND RECOVERY

The taxpayers argue that the judgment of the tax court, the collection of which became the subject of *Larkin v. State ex. rel. Rottas*, 175 Ariz. 417, 857 P.2d 1271 (App.1992), collaterally estops the Department from contending in this litigation that the common fund doctrine is inapplicable in

state tax refund cases. The taxpayers point out that in the *Larkin* judgment the tax court declined to certify a class action, holding that under Arizona law a judgment for or against the state on a tax matter of public and general interest is binding and conclusive on the state. Because the judgment included a common fund fees award and was approved as to form by an assistant attorney general, the taxpayers argue that the Department is now bound by the principle that the common fund doctrine applies in all state tax cases.

We disagree because we do not know whether the issue was actually litigated in *Larkin*, whether there was a full and fair opportunity to litigate it, whether resolution was essential to the decision, or whether there was a final and valid decision on the merits. *See Irby Construction Co. v. Arizona Dept. of Revenue*, 184 Ariz. 105, 107, 907 P.2d 74, 76 (App.1995) (explaining the requisites for the application of collateral estoppel).

THE COURT DID NOT ERR IN AWARDING FEES UNDER THE COMMON FUND DOCTRINE

The common fund doctrine is an exception to the general rule that, in the absence of statute or contract, each side in a litigated case must bear its own attorneys' fees. *See Matter of Estate of Brown*, 137 Ariz. 309, 312, 670 P.2d 414, 417 (App.1983). Under the common fund doctrine a court may award attorneys' fees to counsel for the prevailing side whose efforts in litigation create or preserve a common fund from which others who have undertaken no risk or cost will nevertheless benefit. *See Boeing Co. v. Van Gemert*, 444 U.S. 472, 478, 100 S.Ct. 745, 62 L.Ed.2d 676 (1980); *Steinfeld v. Zeckendorf*, 15 Ariz. 335, 342, 138 P. 1044, 1047 (1914). The purpose of the doctrine is to compensate counsel for producing such benefits and to preclude the unjust enrichment of those who receive the benefits. *See Matter of Estate of Brown*, 137 Ariz. at 313, 670 P.2d at 418.

The Department argues the taxpayers waived any claim for fees under this theory because fees were not sought under the common fund doctrine in the original *Kerr* complaint or in the administrative process. The doctrine was first invoked at the time of the initial appeal to the tax court. The Department has shown no prejudice in this respect and we believe the request for fees under the common fund doctrine came soon enough.

The Department next argues that *Sprague v. Ticonic Nat. Bank*, 307 U.S. 161, 167, 59 S.Ct. 777, 83 L.Ed. 1184 (1939) holds that equitable awards of fees are "appropriate only in exceptional cases and for dominating reasons of justice." It cites *United States v. Brockamp*, 519 U.S. 347, 117 S.Ct. 849, 136 L.Ed.2d 818 (1997), for the proposition that equitable doctrines that may apply in non-tax cases will not be applied in tax refund cases. *Brockamp* is not very helpful. There the court rejected a bid by taxpayers to obtain equitable tolling of the time within which to file for refunds on the ground that their alcoholism or senility was responsible for their delay. Based on an exhaustive review of the federal refund statutes, the court concluded that Congress did not intend courts to read other unmentioned, open-ended equitable exceptions into the statutes. The Department contends that A.R.S. sections 42-115, 42-122, 42-124, 42-129 and 42-139.14 constitute an equally comprehensive statement by our legislature of the procedures and circumstances that permit the recovery of attorneys' fees in tax litigation. The Department also points to our statement in *City of Phoenix v. Paper Distributors of Arizona, Inc.*, 186 Ariz. 564, 566, 925 P.2d 705, 707 (App.1996) to the effect that by enacting Arizona Revised Statutes Annotated ("A.R.S.") section 12-348 the legislature intended "to prescribe a uniform standard for fee awards which was to exclusively apply to all tax cases."

We do not believe our legislature has preempted application of the common fund doctrine. The "uniform standard"

the Department refers to governs the shifting of fees to a losing governmental entity and has nothing to do with spreading fees among all the prevailing taxpayers who benefit from a lawyer's efforts. *See Kadish v. Arizona State Land Dept.*, 177 Ariz. 322, 328, 868 P.2d 335, 341 (App.1993) ("A.R.S. section 12-348 provides when fees shall be awarded against government entities and specifies when fees may not be awarded under the statute, but does not bar awards of fees pursuant to other statutes or equitable theories.").

The Department makes a series of contentions which focus on the dissimilarities between this case and other cases in which the common fund doctrine has been invoked. It cites *Dennis v. State*, 234 Neb. 427, 451 N.W.2d 676, 682 (1990) (*rev'd on other grounds*); *Dennis v. Higgins*, 498 U.S. 439, 111 S.Ct. 865, 112 L.Ed.2d 969 (1991); *Hagge v. Iowa Dept. of Revenue and Finance*, 539 N.W.2d 148, 154, (Iowa, 1995); and *Oklahoma Tax Com'n v. Ricks*, 885 P.2d 1336, 1342 (Okla. 1994). It points out the common fund awards generally result from settlements or recoveries mandated by court order and that such is not the case here. In a similar vein, the Department argues that there is no common fund in this case because the money it owes in refunds has not been segregated from other funds in the Department's control, that the funds are not in the tax court's control, and that the prevailing taxpayers in this case had to file their own refund claims and will not realize a benefit simply by doing nothing, as has occurred in other common fund cases.

The Department's arguments are too technical. We agree with what the Supreme Court of North Carolina said about a similar argument in the case of *Bailey v. State*, 348 N.C. 130, 500 S.E.2d 54 (1998):

> The primary problem faced by courts in determining whether a shifting of fees is appropriate under the common-fund doctrine is deciding whether some finite benefit flows to a determinable group of plaintiffs. If the

> benefit reaped by the representative plaintiffs merely "vindicate[s] a general social grievance," *Boeing* 444 U.S. at 479, 100 S.Ct. at 749, 62 L.Ed.2d at 682, or redounds to the benefit of the public at large, then the common-fund doctrine will not operate to shift the burden of attorney's fees. *Id.* However, in *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975), the Supreme Court noted that the common-fund doctrine has been appropriately applied in cases (1) where the classes of persons benefitting from the lawsuit were small and easily identifiable, (2) where the benefits could be traced accurately, and (3) where the costs could be shifted to those benefitting with some precision. *Id.* at 264 n. 39, 95 S.Ct. at 1625 n. 39, 44 L.Ed.2d at 157-58 n. 39.
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> . . . .
>
> In the present case, the named plaintiffs have recovered a determinate fund for the benefit of every member of the class whom they represent. The defendant's liability has been proven. The qualifications for class membership have been established, and the formula for computing individual refunds has been set. Thus, the judgment fund itself is a quantifiable sum that has been created by the litigation undertaken by the representative plaintiffs. All the remaining class beneficiaries need to do in order to recover their proper refund or credit is to prove their individual claims against the judgment fund. As such, we are persuaded that the recovery at issue in this case properly constitutes a common fund for purposes of shifting attorney's fees under the common-fund doctrine.

Bailey, 500 S.E.2d at 72-73; *Community Care Centers, Inc. v. Indiana Family & Soc. Serv. Admin.*, 716 N.E.2d 519, 544-50 (Ind.App.1999) (rejecting as too narrow the determination in *Hagge* that common fund doctrine does not apply in tax

refund cases). We reject the idea that *Bailey* does not apply because it dealt with a certifiable class. The salient point is that here, as in *Bailey*, counsel were responsible for creating a "common fund."

The Department denies that there was a causal connection between the litigation and the Department's decision to make the refunds. It says that it arrived at the decision to make the refunds based on its interpretation of cases decided in the United States Supreme Court and elsewhere. The trial court was not compelled to accept that as a fact and neither are we. *Harper v. Virginia Dept. of Taxation*, 509 U.S. 86, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993), which the Department says it followed, was decided four years before the Department decided to pay.

Moreover, at a hearing to determine the appropriate amount of the fees, an expert witness testified that based on his knowledge of this case, the refund was the result of nine years of effort on the part of the taxpayers' lawyers. On questioning by the judge, counsel for the Department conceded that the fact that the court had ordered the Department to give notice of the pending litigation contributed greatly to the number of requests for refunds that were filed.

Finally, we address the Department's contention that affirming the tax court will "create new law that will entitle any party who prevails in an administrative or judicial proceeding on an issue of tax law to claim a cut of the monies paid to other taxpayers by the application of the same rules of law." Equitable principles in general, and the common fund doctrine in particular, are not so rigid as the Department supposes. The Department itself calls our attention to the following passage from Rossi *Attorneys Fees, Second Edition* (Lawyers Cooperative Publishing Co.1995):

> Limitations on the common fund doctrine have frequently been announced by the courts. Some decisions have noted that care and caution must be exercised by

> the courts in making these fee allowances. Other courts have stated that since application of the principle is capable of great abuse, it is exercised only in exceptional circumstances and for dominating reasons of justice. An attorney who seeks to impose his fees upon a fund in court has the burden to show that his claim comes fairly and squarely under the equitable principles upon which such fee allowances are made.

We do not believe the tax court disregarded any limitation expressed in the passage from Rossi. This case, which involved nine years of unrelenting opposition on the part of the Department, reflects the exceptional circumstances that support the award.

THE FEE AWARD WAS REASONABLE

The taxpayers called expert witnesses who testified that the fee award was reasonable. The Department did not contest this testimony but now focuses its attack on the amount of the award by arguing that most of the time the attorneys spent related to legal issues and theories that were "separate" from the substantive issue that led to the refund and that, indeed, the taxpayers did not prevail on those issues. Specifically, it believes the court should not have taken into account time the attorneys spent in working on *Kerr I* and *Kerr II*. Since fee requests were denied in *Kerr*, the Department also argues that the doctrine of res judicata bars fees here.

We do not believe the court erred in considering time the attorneys spent on *Kerr I* and *Kerr II*. Hindsight may show that not every theory and procedure the attorneys pursued bore direct fruit, but what the attorneys did in those cases was reasonable and ultimately contributed to the taxpayers' success. For example, it was not unreasonable for the taxpayers to proceed administratively and in the tax court simultaneously to avoid procedural defenses. *See Reich v. Collins*, 513 U.S. 106, 115 S.Ct. 547, 130 L.Ed.2d 454

(1994). So too, it was by virtue of *Kerr I* that the statute authorizing refunds for state and municipal employees was declared unconstitutional and the Department was required to give notice of the pending refund litigation to all taxpayers.

Finally, we do not believe that *res judicata* bars an award of fees. Fees in *Kerr* were not claimed under the common fund doctrine. The taxpayers had not yet succeeded on the ultimate issue and there was no fund from which fees could be paid.

The judgment of the tax court is affirmed.

CONCURRING: NOEL FIDEL, *Presiding Judge*, and E.G. NOYES, JR., *Judge*.

APPENDIX F

COURT OF APPEALS OF ARIZONA
DIVISION 1, DEPARTMENT T

No. 1 CA-TX 92-0010

CLARK J. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN, and JOHN UDALL, on behalf of themselves and all persons resident in Arizona who were employees of the United States Government in any one or all of the years during the period 1984 through the present and who paid Arizona income taxes on federal retirement contributions for any of such years, and all members of the certified class,

Plaintiffs-Appellants,
Cross-Appellees,

v.

PAUL WADDELL, individually and as Director of the Department of Revenue of the State of Arizona, Craig Cormier, individually and Assistant Director of the Arizona Department of Revenue, and all unknown agents, employees, successors in office, assistants and all others acting in concert with them or at their direction, and the Department of Revenue of the State of Arizona,

Defendants-Appellees,
Cross-Appellants.

April 23, 1996

OPINION

TOCI, *Judge.*

Arizona previously exempted from income taxation all contributions to retirement plans paid for by state or local governmental employers, but levied an income tax on

retirement contributions paid for by the federal government. The United States Supreme Court found a similar tax scheme violative of the doctrine of intergovernmental tax immunity in *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989). The taxpayers in this case filed suit in tax court seeking refunds and declaratory and injunctive relief under 42 U.S.C. § 1983 (1981).

On appeal, we held that the trial court erred in not dismissing the taxpayers' state-law claims for failure to exhaust administrative remedies. *Kerr v. Waddell*, 183 Ariz. 1, 8, 899 P.2d 162, 169 (App.1994) ("*Kerr I*"). We further held that taxpayers need not exhaust their administrative remedies to bring a claim under 42 U.S.C. § 1983 in tax court and that the tax scheme violated the doctrine of intergovernmental tax immunity. *Id.* at 10, 14, 16, 899 P.2d at 172, 176, 178. After we decided *Kerr I*, the United States Supreme Court issued its decision in *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995), which held that state courts cannot hear § 1983 claims challenging tax laws when adequate legal remedies exist.

On remand from the Arizona Supreme Court, we vacate our previous opinion and file this opinion in its stead. We hold that the tax court's subject matter jurisdiction to hear state-law tax claims and § 1983 tax claims is subject to the exhaustion of administrative remedies. Because Arizona's administrative tax procedure is an adequate legal remedy that was not exhausted in this case, we find that the trial court lacked subject matter jurisdiction to hear these claims. Accordingly, we reverse the tax court's conclusions on the merits and remand with instructions to dismiss the taxpayers' suit seeking refunds and declaratory and injunctive relief under 42 U.S.C. § 1983.

I. FACTS AND PROCEDURAL BACKGROUND

In *Davis*, the United States Supreme Court considered a Michigan income tax scheme that differed in its treatment between the retirement benefits of state and federal employees. 489 U.S. at 805, 109 S.Ct. at 1502. Michigan defined taxable income in a manner that excluded all retirement benefits received from the state or its political subdivisions, but included retirement benefits received from the federal government. *Id.* at 806, 109 S.Ct. at 1503. The Court held that the discriminatory treatment of federal employees violated the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 (1985), which prohibits discrimination against officers and employees of the federal government because of the source of their income or compensation. *Id.* at 817, 109 S.Ct. at 1508-09.

After the Supreme Court's decision in *Davis*, federal employees Clark Kerr and his wife, Susan Moran, Steve Allen, and John Udall ("the taxpayers") filed a complaint in the tax court seeking relief under 42 U.S.C. § 1983 against the director and assistant director of the Arizona Department of Revenue ("ADOR"), and ADOR itself (collectively "defendants"). The taxpayers attacked Arizona's income tax statutes excluding from state income taxation the retirement contributions of state and local government employees, while taxing the retirement contributions of federal employees. The taxpayers sought a declaration that the state's tax scheme was unconstitutional, an injunction prohibiting defendants from collecting taxes on federal employee retirement contributions, income tax refunds for the years 1984 through 1988, and damages.[1] The taxpayers also moved to certify a class of

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[1] A resident's "gross income" for Arizona income tax has been statutorily defined as "his federal adjusted gross income for the taxable year, computed pursuant to the Internal Revenue Code." Ariz.Rev.Stat.Ann. ("A.R.S.") § 43-1001(2) (Supp.1995) (footnote omitted). Pursuant to 26 U.S.C. § 414(h), state employee retirement contributions were "treated as

approximately 41,500 federal employees, their estates, and survivors. None of the taxpayers prosecuted a claim for refunds through the Arizona administrative process before filing the action in the tax court.

After cross-motions for summary judgment on various issues, the tax court held: (1) the taxpayers were not required to exhaust their administrative remedies before bringing this action; (2) as a matter of law, the individual defendants were qualifiedly immune from liability on the taxpayers' claims for damages pursuant to 42 U.S.C. § 1983; (3) a violation of 4 U.S.C. § 111 is legally cognizable under § 1983; (4) the action was properly maintainable as a class action; (5) as applied A.R.S. section 43-1022(2) violated the doctrine of intergovernmental tax immunity and, thus, unconstitutionally discriminated against the taxpayers; and (6) except to the extent that A.R.S. section 43-1022(2) discriminated against the taxpayers, the Arizona scheme of income taxation of contributions to governmental retirement plans did not violate the doctrine of intergovernmental tax immunity.

With the summary judgment proceedings, the tax court denied the taxpayers' motion for an order directing the state

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employer contributions for the purpose of determining tax treatment under the United States Internal Revenue Code." A.R.S. § 38-781.04(D) (1985) (repealed Mar. 30, 1995) (footnote omitted). The effect of this "pick up" was to remove employee retirement contributions from their federal gross income. Consequently, these contributions were exempt from Arizona income taxation. Additionally, A.R.S. § 43-1022(2) (1980) (amended by Supp.1995) subtracted from Arizona gross income all "[c]ontributions made to the state retirement system, the judges' retirement fund, the public safety personnel retirement system or a county or city retirement plan." These statutes effectively removed all retirement contributions to all state and local government employees from Arizona income taxation. No provision of Arizona law subtracted federal employee retirement contributions from Arizona gross income. Nor did the federal government "pick up" these contributions, thereby removing them from federal (and consequently Arizona) gross income.

to extend to them prospectively the state income tax exemption it had declared violative of the intergovernmental tax immunity doctrine. The tax court also determined that, pursuant to *Chevron Oil Co. v. Huson*, 404 U.S. 97, 92 S.Ct. 349, 30 L.Ed.2d 296 (1971), the legal principle established by *Davis* would not be retrospectively applied. Therefore, the taxpayers were not entitled to refunds of Arizona income taxes previously paid on contributions to federal retirement systems. The tax court entered judgment in accordance with its rulings. The taxpayers appealed. The defendants cross-appealed.

On September 13, 1994, we issued our opinion resolving the appeal and cross- appeal. *Kerr v. Waddell*, 183 Ariz. 1, 899 P.2d 162. We affirmed in part the tax court's grant of declaratory relief, holding: (1) violation of the doctrine of intergovernmental tax immunity, codified as 4 U.S.C. § 111, gave rise to an enforceable right under 42 U.S.C. § 1983; (2) the taxpayers could not be required to exhaust their administrative remedies before bringing claims for damages and declaratory and injunctive relief pursuant to 42 U.S.C. § 1983 in the tax court; (3) A.R.S. section 43-1022(2) violated the intergovernmental tax immunity doctrine by excluding state and local employees' contributions to retirement plans not "picked up" by the employer under 26 U.S.C. § 414(h), but not those of similarly situated federal employees; and (4) the tax court's refusal to declare that the taxpayers were entitled to be exempted prospectively from Arizona income taxation of their contributions to federal retirement plans was not error. Finally, we affirmed the entry of summary judgment in favor of the individual defendants on the taxpayers' claim for damages under 42 U.S.C. § 1983, based on qualified immunity.

We reversed other portions of the tax court's judgment. We held that A.R.S. section 43-1001(2) violated the intergovernmental tax immunity doctrine by taxing federal

retirement contributions while exempting state and local retirement contributions. We held that the adoption of federal adjusted gross income as Arizona gross income in section 43-1001(2) without any compensating deduction of the federal retirement contributions that are automatically included in it discriminated against federal employees. We also held that the tax court lacked subject matter jurisdiction to rule on the taxpayers' state-law refund claims because they failed to exhaust their administrative remedies before ADOR and the Board of Tax Appeals ("BOTA"). We vacated the tax court's decision not to enjoin further enforcement of A.R.S. section 43-1001(2) and remanded for further consideration of that decision in light of our conclusion that section 43-1001(2) unconstitutionally discriminated against federal workers. Finally, because of our resolution of the dispositive issues, we noted that we were not required to address other issues.

Our supreme court granted review and remanded the case to this court for reconsideration in light of the United States Supreme Court's opinion in *National Private Truck Council*, and we requested supplemental briefing on additional issues in light of that case. We now vacate our opinion of September 13, 1994, and reverse the tax court's judgment with directions to dismiss the action in its entirety.

II. DISCUSSION

A. State-Law Claims

Arizona provides an administrative remedy for individuals who believe they have been wrongly denied a tax refund. A.R.S. section 42-130 (1991) provides that if ADOR disallows a claim for refund, it must notify the taxpayer, who then may appeal the decision. The taxpayer may petition for a hearing within ninety days from the date the notice denying the claim is mailed. A.R.S. § 42-122(A) (Supp.1995). ADOR must consider the petition and grant a hearing, if requested. *Id.* The order or decision on the petition becomes

final thirty days after the taxpayer receives notice of the order or decision, unless the taxpayer appeals to BOTA. A.R.S. § 42- 122(C).

The appeal to BOTA may be taken within thirty days of the decision or order of ADOR. A.R.S. § 42-124(A) (Supp. 1995). Then, "the board shall take testimony and examine documentary evidence as necessary to determine the appeal. . . ." *Id.* An unsuccessful taxpayer may then appeal within thirty days of BOTA's final decision or order to the tax court for *de novo* review. A.R.S. § 42-124(B).

The doctrine of exhaustion of administrative remedies is firmly entrenched in Arizona. *Univar Corp. v. City of Phoenix*, 122 Ariz. 220, 223, 594 P.2d 86, 89 (1979). "When a party fails to exhaust all his administrative remedies he is thereby precluded from asserting his right to judicial review and the trial court is without jurisdiction to entertain such action." *Mountain View Pioneer Hosp. v. Employment Sec. Comm'n*, 107 Ariz. 81, 85, 482 P.2d 448, 452 (1971). We held in *Estate of Bohn v. Waddell*, 174 Ariz. 239, 251, 848 P.2d 324, 336 (App.1992), *cert. denied*, 509 U.S. 906, 113 S.Ct. 3000, 125 L.Ed.2d 693 (1993), that taxpayers were required to exhaust the state's administrative remedies before bringing a claim in the tax court for a tax refund.

The taxpayers present multiple arguments in support of their view that administrative exhaustion is not required before filing suit in the tax court. They argue that the administrative refund process conflicts with the tax court's original jurisdiction under the Arizona Constitution over claims involving the legality of taxes. They also contend that it is fatally uncertain, that it does not promote judicial efficiency, that it is futile, and that it is permissive rather than mandatory. Finally, they contend that the legislature's passage of A.R.S. section 35-196.03 (Supp.1995) has stripped BOTA of whatever power it once had to fashion a remedy. According to the taxpayers, because section 35-196.03

conditions the right to a refund on a legislative appropriation, the administrative scheme is inadequate as a matter of law.

We first reject the taxpayers' assertion that section 35-196.03 renders the administrative process futile. Testimony obtained from ADOR officials clearly indicates that monies refunded for taxes paid under an unconstitutional statute are not paid from the state treasury, but from current tax collections. According to undisputed evidence in the record, total tax refunds claimed by the taxpayers do not exceed current tax revenues. Under these circumstances, no legislative appropriation is required to pay refunds. Consequently, A.R.S. section 35-196.03 does not render the administrative process inadequate.

Bohn is dispositive of the remainder of the taxpayers' contentions. We fully considered the exhaustion issue in *Bohn* and will not revisit it here. Pursuant to *Bohn*, the tax court erred to the extent that it held the taxpayers were not required to resort to and exhaust their state administrative remedies before prosecuting their state-law claims against ADOR.[2]

On remand from the supreme court, the taxpayers contend that they were awarded declaratory relief under both 42 U.S.C. § 1983 and the Arizona Uniform Declaratory Judgments Act. Therefore, we must address any state-law claims for declaratory relief. First, the tax court, in granting declaratory relief, only expressly relied on § 1983 and federal constitutional and statutory provisions. The tax court made

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[2] The taxpayers' citation to *Kuhn v. State Dep't of Revenue of State of Colo.*, 817 P.2d 101 (Colo.1991), and *Brumley v. Utah State Tax Comm'n*, 868 P.2d 796 (Utah 1993), is unavailing. In those cases, the administrative agencies were not allowed to consider constitutional issues. Arizona administrative agencies, on the other hand, may. *Bohn*, 174 Ariz. at 248, 848 P.2d at 333. Furthermore, even if an agency is unable to apply constitutional doctrines, other reasons support the exhaustion of administrative remedies. *Id.* at 250, 848 P.2d at 335.

no mention of any independent state grounds for its decision. Additionally, even if declaratory relief were granted on state grounds, we recently held in *Estate of Bohn v. Scott*, 185 Ariz. 284, 915 P.2d 1239 (App.1996), that state-law claims for declaratory and injunctive relief are not jurisdictionally distinct from claims for tax refunds. 185 Ariz. at 290, 915 P.2d at 1245. Therefore, the tax court's jurisdiction to hear state-law claims for declaratory and injunctive relief is subject to the exhaustion of administrative remedies as well.

B. 1983 Claims

In *Kerr I*, we declined to follow other states' decisions that relied on *Fair Assessment in Real Estate Association, Inc. v. McNary*, 454 U.S. 100, 102 S.Ct. 177, 70 L.Ed.2d 271 (1981). Consequently, we held that challenges to state taxing schemes under 42 U.S.C. § 1983 are not subject to exhaustion of administrative remedies. We based our decision on the principles that state law cannot make bringing a § 1983 claim more burdensome than bringing it in federal court, *Felder v. Casey*, 487 U.S. 131, 108 S.Ct. 2302, 101 L.Ed.2d 123 (1988), and that § 1983 claims are not conditioned on exhaustion of state administrative remedies, *Zeigler v. Kirschner*, 162 Ariz. 77, 781 P.2d 54 (App.1989). We distinguished *McNary* on the grounds that there the Supreme Court held that judicial comity barred *federal* courts from hearing § 1983 claims challenging state taxes when there was a plain, adequate, and complete state remedy. Consequently, we held that § 1983 challenges to state taxes in state courts were not conditioned on the exhaustion of administrative remedies. *Kerr I*, 183 Ariz. at 9-10, 899 P.2d at 170-71.

Nine months later, the United States Supreme Court issued its decision in *National Private Truck Council*. The Court held that § 1983 does not allow "either federal or state courts to award injunctive and declaratory relief in state tax cases

when an adequate legal remedy exists." 515 U.S. at ___, 115 S.Ct. at 2355. The decision was

> supported not only by the background principle of federal non-interference discussed in [*McNary*,] but also by the principles of equitable restraint discussed at length in that case. Whether a suit is brought in federal or state court, Congress simply did not authorize the disruption of state tax administration in this way.

Id. at ___, 115 S.Ct. at 2356 (citation omitted).

Although *National Private Truck Council* did not specifically address whether courts could award damages under § 1983 in state tax cases,[3] we interpret it to forbid an award of damages for the same reasons that injunctive and declaratory relief are forbidden. *See McNary*, 454 U.S. at 108-13, 102 S.Ct. at 182-85. Where an adequate remedy exists under state law, no relief of any kind is available in a state court action brought under § 1983 challenging the assessment or collection of state taxes. Taxpayers cannot therefore avail themselves of a claim for damages or injunctive or declaratory relief. Consequently, our holding in *Kerr I* was erroneous. We now examine the taxpayers' claim in light of *National Private Truck Council*.

To determine if the tax court was prohibited from hearing the taxpayers' claim, we must resolve whether an adequate legal remedy in state law exists. *National Private Truck Council*, 515 U.S. at ___ - ___, 115 S.Ct. at 2355-56. Under the Tax Injunction Act, federal courts are divested of jurisdiction to hear state tax cases if there is a "plain, speedy

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[3] The Oklahoma Supreme Court awarded refunds under state law. 515 U.S. at ___, 115 S.Ct. at 2353. In *National Private Truck Council*, the Supreme Court also noted that *Will v. Michigan Dep't of State Police*, 491 U.S. 58, 109 S.Ct. 2304, 105 L.Ed.2d 45 (1989), precluded the taxpayers' claim for refunds against the state under § 1983. 515 U.S. at ___ n. 5, 115 S.Ct. at 2355 n. 5.

and efficient" remedy. 28 U.S.C. § 1341 (1988). The Act does not, however, apply to state courts. Consequently, we are not bound to define an adequate state remedy as one that is plain, speedy, and efficient. We believe, however, that this standard is appropriate for defining an adequate remedy.[4]

A state remedy is plain, speedy, and efficient only if it meets certain minimal procedural requirements. *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503, 512, 101 S.Ct. 1221, 1228-29, 67 L.Ed.2d 464 (1981). These requirements are that the state must provide taxpayers with a full hearing and judicial determination at which they may raise any and all constitutional objections to the tax. *California v. Grace Brethren Church*, 457 U.S. 393, 411, 102 S.Ct. 2498, 2509, 73 L.Ed.2d 93 (1982). Furthermore, the state may provide either predeprivation or postdeprivation remedies to satisfy due process. *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dep't of Bus. Reg. of Florida*, 496 U.S. 18, 36-40, 110 S.Ct. 2238, 2250-52, 110 L.Ed.2d 17 (1990).

The statutory administrative process for challenging the denial of claims for tax refunds provides for hearings both by ADOR, A.R.S. section 42-122(A), and by BOTA, A.R.S. section 42-124(A), (B). At these hearings, both ADOR and BOTA have authority to consider the constitutionality of the challenged tax statute. *Bohn*, 174 Ariz. at 248, 848 P.2d at 333. At the conclusion of the administrative process, the taxpayers have a right to appeal to the tax court for *de novo* review. A.R.S. § 42-124(B).

We find that Arizona's administrative process for challenging the denial of tax refunds meets the requirements of

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[4] As the Supreme Court noted in *McNary*, what is important about defining an adequate remedy is that it "refer to the obvious precept that plaintiffs seeking protection of federal rights in federal courts should be remitted to their state remedies if their federal rights will not thereby be lost." 454 U.S. at 176 n. 8, 102 S.Ct. at 222 n. 8.

National Private Truck Council and *Grace Brethren* and is an adequate state remedy. We, therefore, hold that the tax court did not have subject matter jurisdiction to hear the taxpayers' § 1983 claims absent the exhaustion of their administrative remedies. Because the taxpayers did not exhaust these administrative remedies, the tax court lacked subject matter jurisdiction and erred in failing to dismiss the § 1983 claims.

2. Taxpayers' Argument that the Administrative Remedy is not Plain, Speedy, or Efficient

a. Plain

The taxpayers argue that the administrative remedy is not plain. They contend that the remedy is uncertain because (1) defendants claim there is no statutory right to refunds or other relief under Arizona law, (2) ADOR and BOTA are powerless to declare taxes unconstitutional, (3) Arizona law is uncertain as to how to preserve the right to a refund remedy, (4) defendants have made inconsistent assertions as to BOTA's jurisdiction to hear these claims, and (5) both defendants and BOTA are represented by the same counsel in this appeal. We disagree with each of these contentions.

Citing *American Trucking Associations, Inc. v. Gray*, 483 U.S. 1306, 108 S.Ct. 2, 97 L.Ed.2d 790 (1987), the taxpayers argue that the administrative refund system is rendered uncertain by ADOR's repeated assertion that the taxpayers have no right to refunds or other relief. In *American Trucking*, Arkansas state officials declared their intention to continue collecting taxes closely similar to those held unconstitutional by *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266, 107 S.Ct. 2829, 97 L.Ed.2d 226 (1987), and also to refuse payment under protest of any such taxes. While appeal was pending in the Arkansas Supreme Court after remand, Justice Blackmun, sitting as Circuit

Justice, issued an order directing state officials to escrow the collected taxes until a final decision was reached. 483 U.S. at 1310, 108 S.Ct. at 4.

American Trucking is inapposite. First, it did not involve the question of whether there was a plain, speedy, and efficient remedy in state law. Second, Justice Blackmun found that the taxpayers in that case faced a likelihood of irreparable injury absent injunctive relief. *Id.* at 1309, 108 S.Ct. at 3-4. No such likelihood exists here. Finally, the position taken by ADOR cannot compromise the power of BOTA or the tax court to grant adequate relief. *See Bohn*, 174 Ariz. at 250, 848 P.2d at 335 (BOTA is the final decision maker in the administrative process and is an independent agency, not bound by ADOR's policies).

Defendants next contend that ADOR and BOTA lack the authority to declare tax statutes unconstitutional. We considered this argument in *Bohn*. 174 Ariz. at 249, 848 P.2d at 334. While neither ADOR nor BOTA has the power to declare a statute unconstitutional, both can apply constitutional doctrines to resolve claims. *Id.* This is all that is required of the administrative proceedings.

Defendants argue that the administrative process is not plain because it is uncertain how a taxpayer preserves his right to a refund remedy. First, citing *Bohn*, they claim that the courts have endorsed class refund claims, but neither ADOR nor BOTA will respect class claims. Contrary to the taxpayers' assertions, *Bohn* did not endorse class refund claims. 174 Ariz. at 251, 848 P.2d at 336. "The rule requiring parties to exhaust administrative remedies extends to actions brought on behalf of a class. The cases generally agree that a class action cannot be maintained unless at least one member of the putative class has exhausted applicable administrative remedies." *Id.*

Next, the taxpayers contend that BOTA's regulation providing for a rehearing, Arizona Administrative Code R16-3-121, makes it uncertain how taxpayers preserve the right to a refund after an initial unfavorable decision by BOTA. They claim that, if BOTA has the power to adopt such regulations, then no taxpayer claim can properly be heard by the tax court absent a request for rehearing. On the other hand, they argue, if BOTA does not have authority to adopt such regulations, a rehearing would be a nullity and the taxpayers' time to file an appeal in the tax court begins to run once BOTA's initial decision or order is issued. As a result, they claim that, once receiving a decision from BOTA, a taxpayer cannot know whether he is required to request a rehearing or seek an appeal in the tax court and, thus, must do both.

We do not agree that potentially having to file two appeals in the tax court makes the administrative process less than plain. Neither do we reach the issues of whether BOTA has the authority to adopt a regulation allowing a rehearing or whether, if BOTA has such authority, a rehearing tolls the time for filing of an appeal in the tax court. Nevertheless, we find that the unresolved method of proceeding does not render the administrative procedure fatally uncertain. At most, two actions would be required—one from the initial BOTA denial of the refund request and one from its denial of rehearing. One or the other of these would be sufficient to preserve the taxpayers' right to judicial review of the underlying questions.

The taxpayers next argue that the administrative process is not plain because defendants have made inconsistent claims regarding BOTA's jurisdiction to hear their refund claim. The position taken by defendants in this forum is not binding on BOTA or the courts of this state. If BOTA refuses to hear the taxpayers' refund claims when they reach that stage of the

administrative process, their administrative remedies will then have been exhausted and they can properly appeal to the tax court. A.R.S. § 42-124(B).

Finally, the taxpayers argue that the administrative process is not plain because the same counsel represented both ADOR and BOTA, as *amicus curiae*, on appeal. They contend that administrative tribunals are required to maintain judicial impartiality and that joint representation demonstrates bias, thus violating the taxpayers' right to due process. We disagree. *Withrow v. Larkin*, 421 U.S. 35, 46, 95 S.Ct. 1456, 1463-64, 43 L.Ed.2d 712 (1975), cited by the taxpayers, held that except for those claims of prejudice specifically identified as having a probability of actual bias that is too high to be constitutionally tolerable, "a presumption of honesty and integrity in those serving as adjudicators" must be overcome. 421 U.S. at 47, 95 S.Ct. at 1464. The attorney general's dual representation of ADOR and BOTA, both state agencies, does not overcome the presumption that BOTA would act honestly.

b. Speedy

The taxpayers contend that the administrative remedy is not speedy. They claim that there has been a delay in excess of thirty-one months in the administrative process and that BOTA has an excessive backlog of undecided cases. Additionally, they argue that the legislature's failure to impose reasonable time limits on the administrative process is unconstitutional. We disagree. We find the administrative process sufficiently speedy to satisfy the requirements of *National Private Truck Council*.

Much of the delay in the administrative process results from the taxpayers' position during litigation that their refund claims were protective only, that the claims did not waive their objection to the subject matter jurisdiction of ADOR, and that ADOR should have been disqualified for bias.

Additional delay can be attributed to the uncertainty necessarily created by the tax court action and subsequent appeals, which the taxpayers elected to commence without regard to the administrative process. Consequently, we conclude that most of the delay is the direct result of the taxpayers' choice of the forum in which to litigate their claims.

Citing *Coit Independence Joint Venture v. Federal Savings & Loan Insurance Corp.*, 489 U.S. 561, 109 S.Ct. 1361, 103 L.Ed.2d 602 (1989), the taxpayers argue that Arizona's remedial scheme violates due process because it does not impose reasonable time limits within which administrative agencies must act. *Coit*, however, does not support the taxpayers' position. There, the Court held that the administrative claims procedure promulgated by FSLIC was inadequate because it did not place a reasonable time limit on the consideration of claims. The Court found that the procedure allowed the agency "to delay the administrative processing of claims indefinitely, denying a litigant its day in court, while the statute of limitations runs." 489 U.S. at 587, 109 S.Ct. at 1376. In Arizona, the statutory limitations period does not commence to run until the administrative process is complete. *Third & Catalina Assocs. v. City of Phoenix*, 182 Ariz. 203, 207, 895 P.2d 115, 119 (App.1994). Consequently, taxpayers in Arizona do not lose their right to an action in the tax court as a result of lengthy administrative actions. Furthermore, as suggested above, the unique procedural facts of this case do not exemplify the normal operation of the administrative refund procedure.

c. Efficient

The taxpayers contend that the administrative process is not efficient. They claim that repeated *de novo* review is an undue hardship and that the denial of class relief in the administrative proceedings is inefficient. We disagree.

A system of *de novo* review allows taxpayers to appeal adverse rulings without being bound by conclusions that resulted in the denial of their refund claim. Moreover, the relationship between the entities hearing the appeals necessarily results in *de novo* review. Once a claim for refund is denied, a taxpayer may petition ADOR for a hearing on the denial. A.R.S. § 42-130. Pursuant to an adverse decision at that stage, a taxpayer may appeal to BOTA. A.R.S. § 42-124(A). BOTA is "an independent agency ... not in any way [ ] subject to the supervision or control of [ADOR]." A.R.S. § 42-171(A). *De novo* review is a necessary consequence of BOTA's independence. After an adverse ruling by BOTA, a taxpayer may bring an action in the tax court for a *de novo* appeal. A.R.S. § 42-124(B). At that point, the taxpayer has exhausted his administrative remedies. The tax court's review is *de novo, id.*, because the tax court is not bound by the decisions of the administrative bodies.

Citing *Garrett v. Bamford*, 538 F.2d 63, 71 (3d Cir.), *cert. denied*, 429 U.S. 977, 97 S.Ct. 485, 50 L.Ed.2d 585 (1976), the taxpayers claim that the process is inadequate because the refusal to allow class action in the administrative process requires each taxpayer to bring a separate action. The rule in *Garrett* is taken from *Matthews v. Rodgers*, 284 U.S. 521, 52 S.Ct. 217, 76 L.Ed. 447 (1932). There, the Supreme Court stated, "the jurisdiction . . . to avoid multiplicity of suits at law is restricted to cases where there would otherwise be some necessity for the maintenance of numerous suits between the *same parties*, involving the same issues of law or fact." *Id.* at 529-30, 52 S.Ct. at 221 (emphasis added). Because the alleged multiplicity of suits would not involve the same parties, we do not find the process inefficient. Additionally, "we are not convinced that if a few litigants are successful, each of the others will separately have to file, and carry to a completely litigated conclusion, a full-blown adversary lawsuit." *Mandel v. Hutchinson*, 494 F.2d 364, 367 (9th Cir.1974).

d. Fourteenth Amendment Relief

The taxpayers claim that, under *Reich v. Collins*, 513 U.S. 106, 115 S.Ct. 547, 130 L.Ed.2d 454 (1994), they are entitled to refund relief directly under the Fourteenth Amendment. They argue that the denial of declaratory relief in this case raises due process questions given the prior availability of declaratory relief in state tax actions. We disagree.

In *Reich*, the United States Supreme Court held that Georgia's remedy for illegally collected taxes violated due process because it engaged in a "bait and switch." Prior to the taxpayer's suit in that case, Georgia utilized a post-deprivation remedy, a tax refund statute. After the taxpayer paid the disputed taxes and brought suit to recover them, the Georgia Supreme Court held that the tax refund statute did not apply when the law under which the tax is collected is declared to be unconstitutional. *Id.* at ___, 115 S.Ct. at 549. On remand from the United States Supreme Court, the Georgia Supreme Court found that this system did not violate due process because an adequate predeprivation procedure existed. *Id.* at ___, 115 S.Ct. at 550. The United States Supreme Court held that Georgia's holding out a post-deprivation remedy as the proper recourse for taxpayers, then replacing it with a predeprivation remedy once the taxpayers had no opportunity to utilize it, violated due process. *Id.* at ___ - ___, 115 S.Ct. at 550-51.

While it is true that declaratory relief was accorded in state tax decisions like *State v. Levy's*, 119 Ariz. 191, 580 P.2d 329 (1978), and *O'Neil v. Valley National Bank*, 58 Ariz. 539, 121 P.2d 646 (1942), the existence of these cases has not deprived the taxpayers of a remedy.[5] They are entitled to pursue the post-deprivation remedy of a refund. There has not been a "bait and switch" whereby the taxpayers were

[5] Whether the taxpayers should have resorted to available administrative remedies was never raised in these cases.

induced to pay their taxes in expectation of a postdeprivation refund remedy only to lose their rights to these monies because the refund process was replaced by a predeprivation remedy of which they could not avail themselves.

III. CONCLUSION

We vacate our previous opinion in this appeal. We hold that the taxpayers' § 1983 claims and state-law claims were subject to the exhaustion of administrative remedies and that the tax court erred in failing to dismiss the taxpayers' action for lack of subject matter jurisdiction. Accordingly, we reverse and remand with instructions to dismiss this action in its entirety.

VOSS, P.J., and GRANT, J., concur.

APPENDIX G

COURT OF APPEALS OF ARIZONA
DIVISION 1, DEPARTMENT T

No. 1 CA-TX 92-0010

CLARK J. KERR and BILLIE SUE KERR, husband and wife, SUSAN MORAN, STEVE ALLEN, and JOHN UDALL, on behalf of themselves and all persons resident in ARIZONA who were employees of the UNITED STATES GOVERNMENT in any one or all of the years during the period 1984 through the present and who paid ARIZONA income taxes on FEDERAL RETIREMENT CONTRIBUTIONS for any of such years, and all members of the certified class,

Plaintiffs-Appellants,
Cross-Appellees,

v.

PAUL WADDELL, individually and as DIRECTOR OF THE DEPARTMENT OF REVENUE OF THE STATE OF ARIZONA, CRAIG CORMIER, individually and ASSISTANT DIRECTOR OF THE ARIZONA DEPARTMENT OF REVENUE, and all unknown agents, employees, successors in office, assistants and all others acting in concert with them or at their direction, and THE DEPARTMENT OF REVENUE OF THE STATE OF ARIZONA,

Defendants-Appellees,
Cross-Appellants.

Sept. 13, 1994

Order Correcting Opinion and Denying
Motion for Reconsideration

Nov. 10, 1994.
Review Granted and Remanded July 13, 1995.*

OPINION

TOCI, *Judge*.

This is an action by federal employees Clark Kerr, Susan Morgan, Steve Allen, and John Udall (collectively, "the taxpayers") seeking relief under 42 U.S.C. section 1983 (1988) against the director and assistant director of the Arizona Department of Revenue ("ADOR"), both individually and in their official capacities, and ADOR itself (collectively, "defendants") for discriminatory taxation.

Since 1985, the effect of Arizona law was to tax 100 percent of federal employees' mandatory contributions to federal retirement plans, while exempting from Arizona income taxation most state and local governmental employees' retirement plan contributions. The taxpayers filed for themselves and on behalf of all other residents of Arizona who were employees of the United States government and paid Arizona income taxes on their federal retirement contributions during the period in question. The taxpayers assert that Arizona's scheme for income taxation of mandatory contributions to federal, state, and local governmental retirement systems violates the federal constitutional doctrine of intergovernmental tax immunity codified in 4 U.S.C. section 111 (1988).

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* Editor's Note: Upon grant of review, the matter was remanded to the Court of Appeals for reconsideration in light of the United States Supreme Court's opinion in *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582, 115 S.Ct. 2351, 132 L.Ed.2d 509 (1995).

The Maricopa County Superior Court ("tax court") partially agreed with the taxpayers. It granted the individual taxpayers and the taxpayer class partial declaratory relief on their challenge to Arizona's scheme of taxation of governmental retirement plan contributions. The tax court, however, denied the taxpayers' claims for refunds of alleged overpayments of state income tax and for injunctive relief. Additionally, the tax court granted summary judgment in favor of the individual defendants on the taxpayers' claim for 42 U.S.C. section 1983 damages. The taxpayers appeal.

We reverse the tax court's judgment in part, affirm in part, vacate in part, and remand for further proceedings consistent with this opinion. We summarize the questions on appeal, and our answers to those questions, as follows:

1. Does a violation of the doctrine of intergovernmental tax immunity give rise to an enforceable right under 42 U.S.C. section 1983? Yes. Private individuals who are subjected to discriminatory taxation because of a violation of the doctrine of intergovernmental tax immunity may claim relief under section 1983.

2. Did the tax court lack jurisdiction over the taxpayers' refund claims because the taxpayers failed to exhaust their administrative remedies before ADOR and the State Board of Tax Appeals? Yes. We resolved a similar issue against the taxpayers in *Estate of Bohn v. Waddell*, 174 Ariz. 239, 848 P.2d 324 (App.1992), *cert. denied*, 509 U.S. 906, 113 S.Ct. 3000, 125 L.Ed.2d 693, *reh. denied*, 509 U.S. 941, 114 S.Ct. 15, 125 L.Ed.2d 766 (1993).

3. Does the doctrine of exhaustion of administrative remedies apply to the taxpayers' section 1983 claims for damages and for injunctive relief ? No. We established a rule against administrative exhaustion in *Zeigler v. Kirschner*, 162 Ariz. 77, 83, 781 P.2d 54 (App.1989).

We see no reason to adopt a different rule for section 1983 class action challenges to an unconstitutional taxing statute.

4. Did the tax court properly rule that Ariz. Rev.Stat.Ann. ("A.R.S.") section 43-1022(2) (1980) (amended Supp.1993) was unenforceable because it violated the intergovernmental tax immunity doctrine? Yes. Section 43-1022's exclusion from Arizona gross income of state and local employees' contributions to retirement plans not "picked up" by the employer under section 414(h) of the Internal Revenue Code ("I.R.C.") discriminates against similarly situated federal employees in violation of 4 U.S.C. section 111 and the doctrine of intergovernmental immunity.

5. Did the trial court abuse its discretion in declining to enjoin further enforcement of A.R.S. section 43-1022(2) ? No. The refusal to grant injunctive relief was proper because of the legislature's later repeal of the exclusion and the trial court's ruling on the merits that *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), was not retroactive.[1]

6. Did the trial court err in sustaining A.R.S. section 43-1001(2) (Supp.1993) against the taxpayers' challenge ? Yes. By excluding state and local employees' retirement plan contributions from Arizona gross income, while at the same time including federal employees retirement plan contributions in Arizona gross income, section 43-1001(2) violates 4 U.S.C.

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[1] Nevertheless, we hold that both A.R.S. sections 43-1001(2) and 43-1022(2) violate the intergovernmental tax immunity doctrine. And, in *Harper v. Virginia Dept. of Taxation*, 509 U.S. 86, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993), the United States Supreme Court recently held, as a matter of federal law, that *Davis* is to be applied retroactively.

section 111 (1988) and the doctrine of intergovernmental tax immunity.

7. Did the tax court correctly decline to declare that the taxpayers were entitled to be exempted prospectively from Arizona income taxation of their contributions to federal retirement plans? Yes. The legislature may comply with the mandate in *Davis* by withdrawing benefits from the favored class as well as by extending benefits to the excluded class. Here, the legislature may amend section 43-1001(2), as it has amended section 43-1022, to eliminate an income tax exclusion for contributions to state or local retirement plans.

8. Did the tax court err in granting summary judgment in favor of the individual defendants on the taxpayers' 42 U.S.C. section 1983 damages claim based on qualified immunity. No. The retroactivity of *Davis* remained unsettled until *Harper*. Likewise, the application of 4 U.S.C. section 111 to employee retirement plans cannot be said to have been "clearly established law" until now. Thus the individual defendants were entitled to qualified immunity for their acts in enforcing the state's income tax scheme.

I. BACKGROUND

A long-standing principle once prohibited states from taxing federal instrumentalities. *Estate of Bohn v. Waddell*, 174 Ariz. 239, 244, 848 P.2d 324, 329 (App.1992). This principle became known as the doctrine of intergovernmental tax immunity. *Id.* At one time, neither federal nor state governmental entities could tax the employees of the other. *Id.* Later, courts began to limit the doctrine of intergovernmental tax immunity. *Id.* And, when Congress passed the Public Salary Tax Act of 1939, it specifically codified the requisite nondiscriminatory treatment for intergovernmental taxation. *See* 4 U.S.C. § 411 (1988).

In *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), the United States Supreme Court invalidated Michigan's income tax scheme under these principles. There, Michigan taxed retirement benefits paid by the federal government but exempted from taxation all retirement benefits paid by the state or its political subdivisions. *Id.* at 805-06, 109 S.Ct. at 1502-03. The Supreme Court held that a tax "favoring retired state and local government employees over retired federal employees" violated 4 U.S.C. section 111 and the principles of intergovernmental tax immunity. *Id.* at 817, 109 S.Ct. at 1509.

Later, after other states refused to accord full retroactive effect to *Davis*, and after the Arizona Tax Court ruled in this case that *Davis* did not apply retroactively, the United States Supreme Court held that *Davis* does apply retroactively. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993). Although in *Harper* the Court did not order a refund, it stated that "the Constitution requires Virginia 'to provide relief consistent with federal due process principles.' " *Id.* at __, 113 S.Ct. at 2519 (quoting *American Trucking Ass'n, Inc. v. Smith*, 496 U.S. 167, 181, 110 S.Ct. 2323, 2332, 110 L.Ed.2d 148 (1990) (plurality opinion)). The Court noted that "a State may either award full refunds to those burdened by an unlawful tax or issue some other order that 'create[s] in hindsight a nondiscriminatory scheme.' " *Harper*, 509 U.S. at __ - __, 113 S.Ct. at 2519-20 (quoting *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 40, 110 S.Ct. 2238, 2252, 110 L.Ed.2d 17 (1990)).

II. FACTUAL AND PROCEDURAL HISTORY

A. The Taxpayers' Action

After the Supreme Court's decision in *Davis*, the taxpayers filed a complaint in the tax court. The taxpayers are current

and former federal employees who paid Arizona income taxes within a four year period on their mandatory contributions to federal retirement plans.[2] Neither the individual taxpayers nor the proposed taxpayer class prosecuted claims for refunds of Arizona income taxes through the Arizona administrative process before filing the action in superior court. [3] *See* A.R.S. §§ 42-122 (1991) (appeal to ADOR), 42-124 (1991) (appeal to state board of tax appeals and superior court) and 42-130 (1991) (procedure following a denial of a tax refund).

B. Tax Court Rulings

Ruling on cross-motions seeking summary judgment as to various aspects of the taxpayers' case, the tax court held: (1) the taxpayers were not required to exhaust their administrative remedies before bringing the action; 2) as a matter of law the individual defendants were qualifiedly immune from liability on the taxpayers' claims for damages pursuant to 42 U.S.C. section 1983; (3) a violation of 4 U.S.C. section 111 is legally cognizable under 42 U.S.C. section 1983; (4) the action was properly maintainable as a class action; (5) A.R.S. section 43-1022(2), as applied, violated the federal constitutional doctrine of inter-governmental tax immunity and

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[2] The taxpayers' action sought: (1) a declaration that the Arizona income taxation scheme under which state and local employees' mandatory contributions to state and local retirement systems were exempted from Arizona taxable income, while federal employees' mandatory contributions to federal retirement systems were not, violated 4 U.S.C. section 111 and the doctrine of intergovernmental tax immunities; (2) injunctive relief to prevent continued exaction of the tax on federal employees' retirement contributions; (3) damages against the individual defendants pursuant to 42 U.S.C. section 1983; (4) certification of a class of approximately 41,500 federal employees, their estates and survivors; and (5) refunds for the taxpayer class of all Arizona income taxes paid on federal retirement system contributions in and after 1984.

[3] Since the filing of this action, however, one taxpayer has attempted to exhaust his administrative remedies. *See In re Allen*, No. 932328-B (Ariz. Dept. of Revenue Dec. 13, 1993).

therefore illegally discriminated against the taxpayers; and (6) except to the extent that A.R.S. section 43-1022(2) discriminated against the taxpayers, the Arizona scheme of income taxation of contributions to governmental retirement plans did not violate the doctrine of intergovernmental tax immunity.

Although the tax court declared the state income tax exemption violative of the intergovernmental immunity doctrine, it denied the taxpayers' motion for an order directing the state to extend the income tax exemption to the taxpayers prospectively. The tax court also determined that, pursuant to *Chevron Oil Co. v. Huson*, 404 U.S. 97, 92 S.Ct. 349, 30 L.Ed.2d 296 (1971), the legal principle established by the Supreme Court in *Davis* would not be retroactively applied. Consequently, the taxpayers were not entitled to refunds of Arizona income taxes previously paid on contributions to federal retirement systems.

The tax court entered judgment in accordance with its rulings. The taxpayers appeal. The individual defendants and ADOR cross-appeal.

III. ANALYSIS

A. A Violation of the Doctrine of Intergovernmental Tax Immunity Gives Rise to Relief Under 42 U.S.C. Section 1983

On cross-appeal, defendants contend that as a matter of law an alleged violation of the intergovernmental tax immunity doctrine, as codified in 4 U.S.C. section 111, cannot legally support an action under 42 U.S.C. section 1983. Defendants correctly observe that not all federal statutes secure individual rights for violation of which actions may be brought under 42 U.S.C. section 1983. *See generally Dennis v. Higgins*, 498 U.S. 439, 111 S.Ct. 865, 112 L.Ed.2d 969 (1991); *Golden State Transit Corp. v. City of Los Angeles*, 493 U.S. 103, 110 S.Ct. 444, 107 L.Ed.2d 420 (1989). Defendants argue that neither the Supremacy Clause of the United States

Constitution nor 4 U.S.C. section 111 secure federal rights specifically intended to protect individuals against government intrusion. We disagree.

Defendants' analysis fails to mention *Davis*, the very case that struck down the discriminatory taxation of federal employees' retirement benefits. There, Michigan argued that it could not violate the doctrine of intergovernmental tax immunity unless the state's tax interfered with the federal government's ability to perform its governmental functions. Although not in the context of an analysis of 42 U.S.C. section 1983, the Supreme Court rejected this contention. The Court stated:

> It is true that intergovernmental tax immunity is based on the need to protect each sovereign's governmental operations from undue interference by the other. But it does not follow that private entities or individuals who are subjected to discriminatory taxation on account of their dealings with a sovereign cannot themselves receive the protection of the constitutional doctrine. Indeed, all precedent is to the contrary.

Davis, 489 U.S. at 814, 109 S.Ct. at 1507 (citations omitted); *see also Higgins*, 498 U.S. at 462, 111 S.Ct. at 879 (Kennedy, J., dissenting) ("[T]he Court's rationale creates a § 1983 cause of action when a State violates the constitutional doctrine of intergovernmental tax immunity"); *Hogan v. Musolf*, 163 Wis.2d 1, 471 N.W.2d 216 (1991), *cert. denied*, 502 U.S. 1030, 112 S.Ct. 867, 116 L.Ed.2d 773 (1992) (violations of 4 U.S.C. section 111 are actionable under 42 U.S.C. section 1983).

B. Effect on the Taxpayers' Claims of Failure to Exhaust State Administrative Remedies

1. Effect on State Refund Claims

Defendants further argue on cross-appeal that the tax court erred in holding that the taxpayers were not required to

exhaust the state administrative remedies provided by A.R.S. sections 42-122, 42-124, and 42-130 before bringing claims in the tax court for tax refunds. They assert that our decision in *Estate of Bohn* is dispositive on this issue.

The taxpayers, on the other hand, present multiple arguments in support of their view that administrative exhaustion is not required. First, they argue that the administrative process conflicts with the superior court's original jurisdiction under the Arizona Constitution over claims involving the legality of taxes. Second, they contend that the administrative process is permissive, not mandatory. Third, they assert that the administrative process is futile because neither the ADOR nor the Board of Tax Appeals ("BOTA") has authority to declare Arizona income tax statutes unconstitutional. Finally, they contend that the legislature's passage of A.R.S. section 35-196.03 (Supp.1993) has stripped BOTA of whatever power it once had to fashion a refund remedy. According to the taxpayers, because section 35-196.03 conditions the right to a refund on a legislative appropriation, the administrative scheme is inadequate as a matter of law.

We first reject the taxpayers' argument that A.R.S. section 35-196.03 renders the administrative process futile. Testimony obtained from ADOR officials clearly indicates that monies refunded for taxes paid under an unconstitutional statute are not paid from the state treasury but from current tax collections. According to the undisputed evidence in the record, total tax refunds claimed by the taxpayers do not exceed current tax revenues. Under these circumstances, no legislative appropriation is required to pay refunds. Consequently, section 35-196.03 does nothing to render the administrative process inadequate.

Furthermore, we agree with defendants that *Estate of Bohn* is dispositive on the remaining issues raised by the taxpayers. There, we rejected the taxpayers' argument that article 6,

section 14(2) of the Arizona Constitution [4] gives the superior court original jurisdiction over refund claims. *Id.* 174 Ariz. at 246, 848 P.2d at 331. We held that this constitutional provision "neither expressly nor impliedly prevents the legislature from conditioning the exercise of the superior court's jurisdiction" on the exhaustion of administrative remedies. *Id.* We also disagreed with the taxpayers' argument that the exhaustion of administrative remedies was merely optional. *Id.* at 245-46, 848 P.2d at 330-31. We concluded that even if the taxpayers were correct in their argument that the ADOR cannot determine the constitutionality of tax statutes, exhaustion would be appropriate. *Id.* at 250, 848 P.2d at 335. Thus, the *Estate of Bohn* rationale answers the taxpayers' remaining arguments on the exhaustion of administrative remedies.

2. Effect on 42 U.S.C. Section 1983 Claims

At the same time, given the different procedural facts of this case, it is important that we clearly delineate the reach of our holding in *Estate of Bohn*. There, the taxpayers did not challenge the tax court's dismissal of their section 1983 damage claims against the individual defendants. *See Estate of Bohn*, 174 Ariz. at 242, 848 P.2d at 327. Thus, the defendants in *Estate of Bohn* asserted the defense of failure to exhaust state administrative remedies only in opposing the taxpayers' state-law income tax refund claim. We were never required to decide if the taxpayers' failure to exhaust administrative remedies deprived the tax court of jurisdiction over their 42 U.S.C. section 1983 claims for declaratory and injunctive relief and damages. Here, the taxpayers squarely present this argument.

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[4] Article 6, section 14 of the Arizona Constitution states: "The superior court shall have original jurisdiction of: . . . 2. Cases of equity and at law which involve the title to or possession of real property, or the legality of any tax, impost, assessment, toll or municipal ordinance."

Defendants acknowledge, as they must, that the Supreme Court's decision in *Felder v. Casey*, 487 U.S. 131, 108 S.Ct. 2302, 101 L.Ed.2d 123 (1988), generally invalidates state laws that make bringing a section 1983 claim in state court more burdensome than if brought in federal court. *See also Zeigler v. Kirschner*, 162 Ariz. 77, 83, 781 P.2d 54, 60 (App.1989) (failure to exhaust administrative remedies did not preclude plaintiffs' 42 U.S.C. section 1983 claim). Defendants base their argument for the dismissal of the taxpayers' section 1983 claims, however, on a line of state court cases that rest on the Supreme Court's decision in *Fair Assessment in Real Estate Ass'n, Inc. v. McNary*, 454 U.S. 100, 102 S.Ct. 177, 70 L.Ed.2d 271 (1981).

In *McNary*, the Supreme Court held that the doctrine of judicial comity barred *federal courts* from granting relief in section 1983 actions challenging the validity of state tax systems where state judicial remedies were plain, adequate and complete. *Id.* at 116, 102 S.Ct. at 186. A number of state decisions have held that *McNary* creates an exception to the general rule of *Felder*.[5] These cases establish that in section 1983 actions involving state taxes, *McNary* permits state statutory and common law rules that condition the exercise of state court jurisdiction on prior exhaustion of state administrative remedies.

Defendants, however, rely on two state court decisions, *Nutbrown v. Munn*, 311 Or. 328, 811 P.2d 131 (1991), *cert. denied*, 502 U.S. 1030, 112 S.Ct. 867, 116 L.Ed.2d 773 (1992), and *Hogan*, 163 Wis.2d 1, 471 N.W.2d 216, to support their argument that administrative exhaustion is

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[5] *See, e.g., Boughton Trucking & Materials, Inc. v. County of Will*, 229 Ill.App.3d 576, 171 Ill.Dec. 299, 593 N.E.2d 1119 (1992); *Dean v. Kansas*, 250 Kan. 417, 826 P.2d 1372 (1992), *cert. denied sub nom., Zarda v. Kansas*, 504 U.S. 973, 112 S.Ct. 2941, 119 L.Ed.2d 566 (1992); *Zarda v. Kansas*, 250 Kan. 364, 826 P.2d 1365 (1992), *cert. denied*, 504 U.S. 973, 112 S.Ct. 2941, 119 L.Ed.2d 566 (1992).

required as a precondition to the assertion of a section 1983 claim. We are not persuaded by these decisions.

Turning first to *Hogan*, we think that to the extent it held that administrative exhaustion is a precondition to asserting a section 1983 claim, the case was incorrectly decided. *Hogan* relies on the holding in *McNary* that a federal court may not entertain a taxpayer's section 1983 claim until the taxpayer has exhausted state administrative remedies. But the *McNary* analysis required only that a taxpayer exhaust the state administrative procedures that are a precondition to suit in state court. Thus, the Wisconsin court went beyond the holding in *McNary* and interpreted the exhaustion doctrine to require not only the exhaustion of administrative remedies, but the exhaustion of all available judicial remedies prior to bringing a section 1983 action. *Hogan*, 471 N.W.2d at 223-24. This result appears to violate the federal constitutional doctrine that a state court may not refuse to entertain a federal cause of action. *See Howlett v. Rose*, 496 U.S. 356, 369, 110 S.Ct. 2430, 2439, 110 L.Ed.2d 332 (1990).

Furthermore, both *Nutbrown* and *Hogan* involve administrative remedies not available in Arizona. As defendants point out, the statutes in Oregon and Wisconsin extend *judicial* powers to their administrative tax agencies. The administrative agencies in both states have the authority to declare taxing statutes unconstitutional. *See Nutbrown*, 811 P.2d at 141 ("Oregon administrative agencies have the power to declare statutes and rules unconstitutional."); *Hogan*, 471 N.W.2d at 224 (ADOR has the "authority to determine whether . . . the Wisconsin taxing scheme also violates federal law or the constitution."). And, in Oregon, the administrative remedies available to the taxpayers include declaratory and injunctive relief as well as the right to a refund. *Nutbrown*, 811 P.2d at 139.

In contrast, although the ADOR has the power to apply constitutional doctrines in tax cases, it does not have the

power to determine whether the Arizona income tax scheme is unconstitutional. *Estate of Bohn*, 174 Ariz. at 248-50, 848 P.2d at 333-35. Furthermore, under the Arizona administrative scheme, the administrative refund process contains no provision for declaratory or injunctive relief. Arizona law narrowly focuses on administrative challenges to deficiency assessments and denials of specific refund claims. *See* A.R.S. §§ 42-122, 42-124 and 42-130. Thus, neither *Hogan* nor *Nutbrown* is squarely applicable here as precedent.

Furthermore, we reject defendants' argument that because federal retirees filing section 1983 claims in federal courts would be required to exhaust any applicable state remedies, a similar rule should apply in state courts. Although both *Hogan* and *Nutbrown* reach this conclusion, we think the better rule is that announced by the Pennsylvania Supreme Court in *Murtagh v. County of Berks*, 535 Pa. 50, 634 A.2d 179 (1993), *cert. denied*, 511 U.S. 1017, 114 S.Ct. 1397, 128 L.Ed.2d 71 (1994). There, the court observed:

> While exhaustion of state statutory remedies is required in federal courts, exhaustion is not required in the courts of this state insofar as the action is a class action challenging the constitutionality of a system of property tax assessment. This is so because the principle of comity that causes a federal court to refrain from exercising jurisdiction over section 1983 tax assessment cases has no relevance to a class action challenging, in state court, the constitutionality of a system of property tax assessment.

Id. 634 A.2d at 185. This conclusion is consistent with the view of one commentator:

> "The essential federalism policy behind the Court's decision in *McNary* and the Tax Injunction Act of protecting the states from federal judicial interference with their core function of tax collection is simply not

> compromised when a *state* court declares a state taxation policy unconstitutional. . . . [A] major interference with state tax policy results from a state court's declaration that its taxation policy is unconstitutional. But this is true whether the ruling is made under a state law remedy or section 1983. . . . If a state tax is found unconstitutional, the elements of a 1983 claim for relief are satisfied and section 1983 should be available."

Sandra B. McCray, *U.S. Supreme Court Permits Commerce Clause Suits Under Civil Rights Statute*, 1 J. Multistate Tax'n 258, 262 (John L. Coalson, et al. eds. 1992) (quoting Martin A. Schwartz and John E. Kirklin, *Section 1983 Litigation: Claims, Defenses, and Fees*, 803-804 (2d ed. 1991))

For several reasons, we think the above rationale should be adopted here. The rule of exhaustion of administrative remedies is a rule of judicial administration that is usually applied because of an express statutory mandate. *Estate of Bohn*, 174 Ariz. at 246, 848 P.2d at 331. Arizona has no express statute that requires the exhaustion of administrative remedies before one may attack the constitutionality of a tax statute. Further, our supreme court has permitted injunctive relief to restrain the discriminatory enforcement of the tax laws. *See State Tax Comm'n v. Superior Court*, 104 Ariz. 166, 169, 450 P.2d 103, 106 (1969) (Injunction is an appropriate remedy where the "mode of assessment produces discriminatory inequality on the same class of property."); *McCluskey v. Sparks*, 80 Ariz. 15, 19-20, 291 P.2d 791, 794 (1955) (Injunction is appropriate remedy when it is "clearly shown that assessments are the result of systematic and intentional conduct.").

More importantly, in *Zeigler* this court previously held that section 1983 claims are not subject to dismissal for failure to exhaust state administrative remedies. There, we said:

> The holding in *Felder* clearly demonstrates that a state court may not condition a plaintiff's § 1983 rights upon

> the exhaustion of state administrative remedies. Accordingly, we hold that plaintiffs' § 1983 claims in the instant case were not subject to dismissal because of the named plaintiffs' failure to exhaust their state administrative remedies.

Zeigler, 162 Ariz. at 83, 781 P.2d at 60. We see no valid reason to create an exception to this rule in cases involving a section 1983 class action challenge to an unconstitutional state taxing scheme.

Furthermore, the reasons we stated for requiring administrative exhaustion of refund claims, *see Estate of Bohn*, 174 Ariz. at 245-46, 848 P.2d at 330-31, are not applicable to taxpayers section 1983 claims for injunctive relief. It is one thing to require resort to the administrative process to seek an individual refund; it is quite another to require a class injured by the administration of an unconstitutional tax scheme to seek redress in the first instance from those who are the very targets of section 1983 legislation. Thus, even if we were to follow *McNary*, it would not be applicable here. *McNary* 's exhaustion rule only applies where the state remedies are "plain, adequate, and complete." *McNary*, 454 U.S. at 116, 102 S.Ct. at 186. We conclude that in the case of the taxpayers' section 1983 class action challenge to the Arizona tax scheme, the administrative process is not adequate.

We reach this conclusion for several reasons First, in the administrative process, an ADOR hearing officer has already refused to consider a federal taxpayer's individual refund claim in light of the United States Supreme Court's holding in *Davis*. [6] Instead, ADOR has stated "[w]hether Arizona's taxing scheme violates the intergovernmental tax immunity doctrine and 42 U.S.C. § 111 [sic] and is therefore uncon-

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[6] *See In re Allen*, No. 932328-B (Ariz. Dept. of Revenue Dec. 13, 1993).

stitutional is left for tribunals empowered to pass judgment on such questions." Consequently, this section 1983 class action challenge to the constitutionality of the Arizona tax scheme will, in the long run, significantly reduce the inconvenience, inefficiency, delay, and expense involved in countless futile, separate administrative actions. Second, because of our holding today that Arizona's tax scheme violates the intergovernmental tax immunity doctrine, the taxpayers may be entitled to injunctive relief to prevent the continued discriminatory tax treatment of federal employees. No injunction may be granted in the administrative process. Consequently, the tax court correctly held that the taxpayers' failure to exhaust state administrative remedies did not deprive it of jurisdiction to consider and resolve their claims for declaratory and injunctive relief and damages under 42 U.S.C. section 1983.

3. Response to Dissent

Several words about the dissent. The dissent argues that it is "dichotomous" to exempt section 1983 claims from administrative exhaustion based on the ADOR's inability to decide constitutional questions, when we held in *Bohn* that administrative refund claims must be exhausted. As we point out above, however, there is a significant difference between the administrative refund claims in *Bohn* and the section 1983 class action claims in this case. In *Bohn*, the taxpayers did not appeal the dismissal of their section 1983 claims. Thus, *Bohn* did not involve the issue of administrative exhaustion of section 1983 claims. Because the statutory administrative process specifically provided a method for paying the taxpayers refund claims, we held in *Bohn* that administrative exhaustion was required as a pre-condition to suit in the tax court.

Here, however, unlike *Bohn*, the federal taxpayers class action also challenges the continued enforcement of a tax scheme that unconstitutionally discriminates against federal

employees. Upon remand, the taxpayers may be entitled to injunctive relief to prevent the state from continuing to enforce the unconstitutional provisions of A.R.S. section 43-1001(2). Because the ADOR cannot grant injunctive relief to the taxpayers and because the ADOR has already refused to apply constitutional doctrines to the one federal taxpayer in this case who has attempted to exhaust his administrative remedies, the administrative process does not provide an adequate remedy at law.

The dissent also contends that it is illogical to deem the administrative claims process inadequate based on the ADOR's inability to issue an injunction, because by statute even the courts are generally denied the power to "prevent or enjoin the collection of any tax." The dissent, however, concedes that the only exception to this rule exists where the court finds a taxing scheme unconstitutional. We have, of course, in this opinion reached that conclusion. Consequently, because the tax court clearly has the power to enjoin the continued enforcement of section 43-1001(2), there is nothing illogical in holding that administrative remedies are inadequate because administrative bodies do not have the same power.

The dissent further argues, for essentially three reasons, that the majority's approach creates bad precedent. First, the decision gives Arizona taxpayers the right to ignore state administrative exhaustion requirements when filing section 1983 claims in state courts. Second, Arizona taxpayers can now file their claims directly in federal courts because the Arizona Court of Appeals has deemed state remedies inadequate. Third, the tax court will have to assume the role of ADOR in "reviewing refund claims under the guise of section 1983 without the benefit of any factual record."

Unfortunately, this misconstrues our holding. Following *Bohn,* we held above that the taxpayers' refund claims—as distinguished from their section 1983 claims for declaratory

and injunctive relief and damages—are subject to administrative exhaustion. Thus, contrary to the dissent, refund claims "under the guise" of section 1983 are not exempt from the administrative exhaustion requirements. The taxpayers' class action claims under 42 U.S.C. section 1983 for declaratory and injunctive relief and damages for the administration of an unconstitutional tax scheme, however, are different. In these particular circumstances, the taxpayers' failure to exhaust state administrative remedies does not deprive the tax court of jurisdiction to hear and determine the taxpayers' section 1983 claims. And, although the dissent argues that the court in *McNary* did not intend to allow taxpayers filing section 1983 claims in the federal court to circumvent the exhaustion requirement because of inadequate administrative remedies, that is precisely what *McNary* says. *McNary* requires exhaustion as a pre-condition to asserting a section 1983 tax claim in federal court only where the state remedies are "plain, adequate, and complete." *McNary*, 454 U.S. at 116, 102 S.Ct. at 186. Here, for the reasons mentioned above, the state remedies are not "plain, adequate and complete."

C. The Federal Tax Code "Pick Up" Provisions

The federal tax code draws a distinction between "employers' contributions" and "employees' contributions" to a qualified pension plan. *See Howell v. United States*, 775 F.2d 887, 887 (7th Cir.1985). Although it makes no difference to the employer how such contributions are treated, the tax consequences to the employee are significant, depending on whether the pension plan contribution is considered an employees' contribution or an employers' contribution. Thus, the employer is treated the same whether it pays an employee a salary of $30,000 and contributes an additional $3,000 to a pension plan on the employees' behalf or instead pays $33,000 to an employee who in turn contributes $3,000 to a pension plan. *See id.* In both cases the

employer deducts the entire $33,000 as a business expense. If the contribution to the pension plan is made by the employer, however, the tax to the employee on the contribution is deferred until retirement. But if the contribution is made by the employee, the amount of the contribution is presently taxable. This distinction between employers' contributions and employees' contributions has been described as one example of the "dominance of form over substance in the [federal] tax code." *Id.*

Rather than simplifying the matter by treating both types of contributions the same, in 1974, Congress passed 26 U.S.C. section 414(h)(2). This statute allows state and local government employers (but not private employers) to control the tax consequences to employees of their qualified pension plan contributions. *See Howell*, 775 F.2d at 888. Section 414(h)(2) provides that if a state or local government's pension plan contributions "'are designated as employee contributions but [the] employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.'" *Id.* (quoting 26 U.S.C. § 414 (h)(2)). Thus, through the device of the public employer electing to "pick up" the employees' contribution to a qualified pension plan, employees' contributions to such plans are treated the same as employers' contributions. *See id.*

D. The Arizona Tax Scheme

During the time relevant to this case, a resident's "gross income" for Arizona income tax purposes was defined as his "federal adjusted gross income for the taxable year, computed pursuant to the Internal Revenue Code." A.R.S. § 43-1001(2) (1980). This is the starting point for determining a taxpayer's Arizona adjusted gross income and taxable income. *See* A.R.S. §§ 43-1001(1), (2), (11) (1980) (amended Supp.1993) (definitions); A.R.S. §§ 43-1021 through 43-1026 (1980) (amended Supp.1993) (adjustments to Arizona gross income);

A.R.S. §§ 43-1041 through 43-1043 (1980) (amended Supp.1993) (deductions and personal exemptions).

Effective May 3, 1985, the legislature adopted "pick-up" provisions authorized by 26 U.S.C. section 414(h) (1988). According to these provisions, after approval by the Internal Revenue Service, electing state and local governmental employers would "pick up" the retirement contributions that would otherwise normally have been paid by their employees. Such contributions were then excluded from the employee's gross income for federal income tax purposes. *See* A.R.S. § 38-781.04(D) (1985) (amended Supp.1993) (state retirement system); *see also* A.R.S. § 38-810(D) (1985) (amended Supp.1993) (elected officials retirement plan, effective August 7, 1985); A.R.S. § 38-892 (Supp.1993) (corrections officers' retirement plan, effective July 1, 1986). The combined effect of A.R.S. section 43-1001(2) and the "pick-up" provisions covering most state and local retirement plans was to exempt the affected state and local employees' retirement contributions from both federal and Arizona income taxation.

Unlike the Arizona legislature, however, the United States Congress has not enacted a "pick-up" provision excluding from federal gross income federal employees' contributions to their retirement plans. Accordingly, federal retirement plan contributions are automatically included in federal employees' Arizona gross income. Because no provision of Arizona law subtracts federal employees' retirement contributions from their Arizona gross income in computing Arizona taxable income, federal retirement contributions are fully subject to Arizona income taxation. Further, because no provision of Arizona law adds back "picked-up" state or local employee retirement plan contributions in determining Arizona taxable income, the latter contributions escape Arizona income taxation entirely.

Additionally, during the years in question, A.R.S. section 43-1022(2) subtracted from Arizona gross income all "[c]ontributions made to the state retirement system, the judges' retirement fund, the public safety personnel retirement system or a county or city retirement plan." [7] This exemption excluded from Arizona gross income all contributions to all state and local retirement plans not "picked up" by the employer pursuant to 26 U.S.C. section 414(h). Section 43-1022, however, contains no similar gross income subtraction for contributions made by federal employees to federal retirement plans.

1. Legal and Procedural Background

In ruling on the taxpayers' motion for declaratory judgment, the tax court made the following findings and conclusions:

> (1) Federal, Arizona, and local Arizona governmental employees' contributions to their respective retirement systems (or plans) are part of their compensation.
>
> (2) Social Security retirement benefits make up a part of the retirement benefits which some, but not all, state and local employees can look forward to receiving at retirement.
>
> (3) Social Security retirement benefits make up a part of the retirement benefits which some, but not all, federal employees can look forward to receiving at retirement.
>
> (4) In comparing the current financial burden on federal, state, and local governmental employees of contributing toward their respective retirement benefits, it is

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[7] In two stages, the Arizona Legislature deleted the exemption for contributions to state and local employees retirement plans. *See* Act of June 29, 1989, 1989 Ariz.Sess.Laws 1596, 1604-06; Act of May 21, 1991, 1991 Ariz.Sess.Laws 529, 536-37.

necessary to take Social Security benefits and taxes (or contributions) into consideration.

(5) No generalization can be made as to whether the retirement benefits of any particular group of federal employees are likely to be better than those of a similarly situated group of state or local employees.

Because the tax court ultimately held that its rulings would be applied prospectively only and that in consequence no refunds would be ordered, the tax court did not elaborate on the way in which Social Security benefits and taxes would be taken into consideration.

On the underlying immunity issue, the tax court declared the law as follows:

A.R.S. § 43-1022(2) violates the federal constitutional doctrine of intergovernmental tax immunity, because (a) it gives preferential treatment to the class or group consisting of Arizona state and local governmental employees who make mandatory contributions to state or local retirement systems which do not qualify for "pick-up" (and therefore exclusion from [federal adjusted gross income]) of those contributions and (b) it does not give similar treatment to federal governmental employees residing in Arizona who make mandatory contributions to federal retirement systems which the federal government has chosen not to make excludable from [federal adjusted gross income].

. . . .

IT IS FURTHER ORDERED declaring that except to the extent that A.R.S. § 43-1022(2) operates to discriminate against Plaintiffs, the Arizona scheme of income taxation of contributions to federal, state, and local governmental retirement plans does not violate the federal constitutional doctrine of intergovernmental tax immunity. Any disparity in federal and Arizona income

tax treatment of such contributions resulting from the application of I.R.C. § 414(h) and related provisions of federal law does not fall within the scope of *Davis*.

2. Validity of A.R.S. Sections 43-1001(2) and 43-1022(2) Under 4 U.S.C. Section 111

The parties' opposing arguments are based on two statutes, A.R.S. sections 43-1001(2)[8] and 43-1022(2). The taxpayers contend that A.R.S. section 43-1001(2) illegally discriminates against federal employees. They argue that it is discriminatory because it excludes from Arizona gross income the "picked up" retirement plan contributions of state and local employees to state and local plans, while including in gross income the contributions of federal employees to federal retirement plans. Defendants dispute this. Defendants also argue that the tax court erred in ruling that because A.R.S. section 43-1022(2) subtracted from Arizona gross income the non-"picked-up" retirement plan contributions of state and local employees to state and local plans, the statute illegally discriminated against federal employees.

a. A.R.S. Section 43-1001(2)

As we explained previously, through 26 U.S.C. section 414(h), the United States Congress chose to exclude from gross income for federal income tax purposes employee contributions to state or local governmental retirement plans that the governmental employer elects to "pick-up." Section 414(h)(2) states in part:

> [I]n the case of any plan established by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, where

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[8] A.R.S. § 43-1001(2) (1980) states "'Arizona gross income' of a resident individual means his federal adjusted gross income for the taxable year, computed pursuant to the Internal Revenue Code." (Footnote omitted.)

> the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Congress has not chosen to extend this effective deferral of federal taxes to employees of the federal government. This discrimination within the federal income tax scheme does not violate 4 U.S.C. section 111 or the intergovernmental tax immunity doctrine. That doctrine prohibits only state discrimination against employees of the United States, not discrimination by the United States in favor of state employees.

Arizona has chosen, however, to designate as its residents' "Arizona gross income," their federal adjusted gross income determined pursuant to the I.R.C. *See* A.R.S. § 43-1001(2). The result is that state and local employees' contributions to section 414(h) retirement plans are not only excluded from their gross income for federal tax purposes, but also, automatically excluded from their gross income for state tax purposes. At the same time, federal employees' contributions to federal retirement plans are included in their gross income for federal income tax purposes, and thus included in their gross income for Arizona income tax purposes.

The tax court held that this disparate Arizona income taxation of federal, state, and local employees' contributions to their respective retirement systems resulted from the application of section 414(h) and related provisions of federal law. Consequently, the tax court concluded that the Arizona statute did not violate the doctrine of intergovernmental tax immunity. Defendants make the same argument on appeal. We disagree.

Both the tax court and defendants err in relying upon "the source of the pay or compensation" to extricate Arizona's scheme for taxation of federal, state, and local retirement

contributions from the prohibited category of discrimination. The thrust of defendants' reasoning is found in their statement that "[t]he only obstacle to the exclusion of federal plan contributions [from Arizona income taxation] is the federal employer, who has refrained from acting to 'pick up' contributions." Their implicit major premise, which is incorrect, is that Arizona had no choice other than to adopt federal adjusted gross income without modification as part of the state income tax scheme.

Contrary to the tax court's ruling and defendants' reasoning, however, it was ultimately Arizona legislative action that imposed the discriminatory tax scheme. In other words, it was not federal legislative action, but state legislative action that caused state and local retirement contributions to be exempted from Arizona income taxation while federal retirement contributions were not. No provision of law to which we are cited required Arizona to adopt federal adjusted gross income in determining Arizona taxable income.

Further, as we observe above, the Arizona income tax scheme uses federal adjusted gross income only as its starting point. In arriving at Arizona adjusted gross income, some sixteen items of income are added to Arizona gross income, and twenty are subtracted from it. *See* A.R.S. §§ 43-1021 (Supp.1993) (additions to Arizona gross income); A.R.S. § 43-1022 (Supp.1993) (subtractions from Arizona gross income). For example, Arizona adds to gross income a taxpayer's interest income from non-Arizona political subdivisions, which the I.R.C. excludes from federal income taxation. *See* A.R.S. § 43-1021(4). Similarly, Arizona subtracts from Arizona gross income all interest received on United States government obligations, and portions of social security benefits and railroad retirement benefits, which the federal government can tax but states cannot. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S.Ct. 692, 74

L.Ed.2d 562 (1983); 31 U.S.C. § 3124(a) (1988); 45 U.S.C. § 231m(a) (1988); A.R.S. §§ 43-1022(6), (17) (Supp.1993).

Indeed, as we stated above, after the taxpayers filed this action, the Arizona legislature acted to eliminate discriminatory taxation as between federal employees and those state and local employees whose retirement plans have not taken advantage of the "pick-up" authorized by 26 U.S.C. section 414(h). *See* Act of June 29, 1989, 1989 Ariz.Sess.Laws 1596, 1604-06; Act of May 21, 1991, 1991 Ariz.Sess.Laws 529, 536-37. Whatever the treatment accorded by federal law to federal and state retirement plan contributions, Arizona was not compelled to discriminate against federal employees.

The single case on which defendants rely, *Howell v. United States*, 775 F.2d 887 (7th Cir.1985), does not support their position. *Howell* holds only that a state employee's ability to exclude payments to a state retirement plan from his federal gross income for a given year depends on whether his employer in fact designated the contributions as "picked up" pursuant to section 414(h) for that year. *Id.* at 890. Contrary to defendants' implicit argument, *Howell* did not hold that a state is required to accept and implement for state income tax purposes all other employers' elections under section 414(h).

What defendants' reasoning ultimately boils down to is that indirect discriminatory taxation that is not specifically intended to operate as such, is not discriminatory at all. Defendants cite no authority that would support this idea in the tax arena, and we are aware of none. The tax court erred in holding that A.R.S. section 43-1001(2) did not violate the governmental immunity doctrine.

b. A.R.S. Section 1022(2)

The tax court held that former section 43-1022(2) violates the doctrine of intergovernmental tax immunity because it provides a subtraction from Arizona gross income for

contributions to non-section 414(h) state and local retirement plans, but provides no corresponding subtraction for contributions to federal retirement plans. We agree with the tax court.

Defendants first attack the tax court's ruling on the ground that A.R.S. section 43-1022(2) does not discriminate against federal employees. Although their argument is involved, it again comes down to the proposition that it is the limited scope of the federal tax benefits granted under 26 U.S.C. section 414 that results in disparate treatment, rather than A.R.S. section 43-1022(2).

Defendants' argument is again premised on the mistaken view that the discriminatory taxation of federal employees occurs only because Congress has chosen not to extend the federal tax benefits of section 414(h) to federal employees. The disparate treatment of the two groups, however, actually results from Arizona's decision to exclude from state income taxation all retirement contributions to state and local plans that do not participate in the employer pick-up scheme provided by section 414(h). Arizona was neither compelled to extend this advantage to state and local employees, nor to deny the same advantage to similarly situated federal employees.

Defendants next assert that because of the agreements by which most state and local employee groups have become participants in the federal social security system, *see* A.R.S. § 38-701 through 38-781.44 (1985 & Supp.1993),[9] social

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[9] 42 U.S.C. section 418 (1988) permits states and their political subdivisions to join the federal social security system. In 1951, the Arizona Legislature adopted provisions which are currently codified as A.R.S. sections 38-701 through 38-781.44 (1985 & Supp.1993) authorizing the state and its political subdivisions to enter into agreements pursuant to 42 U.S.C. section 418. *See* Act of March 28, 1951, 1951 Ariz. Sess.Laws 349. Arizona voters later repealed an existing retirement system for state employees, and the state entered into an agreement with

security is actually an integral part of the retirement scheme for such employees. Defendants contend that when one takes into account the required taxable contributions to the federal social security system made by such state and local employees, Arizona income taxation of federal employees' retirement contributions is "comparable" to that of state and local employees, and therefore legal. Defendants urge:

> [M]ost state and local employees contribute significantly more of their wages to government plans than federal employees while the tax burden is comparable. In general, when Social Security tax is included, the vast majority of state employees pay tax on approximately 6% of contributions, while the vast majority of federal employees pay tax on 7%.
>
> Government employee contributions are not available to the employee until termination or retirement. Since most Arizona state and local employees must contribute a far greater percentage to Social Security and a state or local retirement plan than federal employees, a state tax scheme that taxes a comparable percentage for both classes of employees is not discriminatory.

Similarly, defendants argue that because of 26 U.S.C. section 414(h), and the difference in the economic burdens of funding retirement systems, constitutionally significant differences exist between federal employees on the one hand, and state and local employees on the other. According to defendants, these differences validate the exemption of state and local retirement plan contributions from Arizona income taxation under A.R.S. section 43-1022(2). *See Davis*, 489

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the U.S. Government to extend social security participation to state employees retroactive to January 1, 1951. As of April 20, 1983, states and their political subdivisions which have agreed to participate in the federal social security system cannot withdraw from that agreement, though non-participating governmental units may still be added.

U.S. at 816, 109 S.Ct. at 1508 ("[T]he relevant inquiry is whether the inconsistent tax treatment is directly related to, and justified by, 'significant differences between the two classes.' ") (quoting *Phillips Chemical Co. v. Dumas Indep. Sch. Dist.*, 361 U.S. 376, 383, 80 S.Ct. 474, 479, 4 L.Ed.2d 384 (1960)). In any event, argue defendants, any illegal discrimination is confined to minor subclasses of federal employees and state and local employees, and this discrimination should not cause A.R.S. section 43-1022(2) to be invalidated entirely.

Defendants' analyses are contrary to federal law as previously interpreted by the Supreme Court. A state's rationale for discriminatory treatment of persons who deal with the federal government must be rejected if, when the rationale is applied evenhandedly, it would not produce the disparity the state's law creates in practice. *See Phillips Chemical*, 361 U.S. at 384-85, 80 S.Ct. at 479-80 (rejecting proffered rationale for State's unfavorable tax treatment of lessees of federal property, because evenhanded application of the rationale would have resulted in inclusion of some lessees of state property in the disfavored class as well). In *Davis*, the Court employed the same analysis in rejecting contentions similar to those made by defendants here:

> [T]he State argues that its retirement benefits are significantly less munificent than those offered by the Federal Government, in terms of vesting requirements, rate of accrual, and computation of benefit amounts. The substantial differences in the value of the retirement benefits paid the two classes should, in the State's view, justify the inconsistent tax treatment.
>
> Even assuming the State's estimate of the relative value of state and federal retirement benefits is generally correct, we do not believe this difference suffices to justify the type of blanket exemption at issue in this case. While the average retired federal civil servant

> receives a larger pension than his state counterpart, there are undoubtedly many individual instances in which the opposite holds true. A tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits, as Michigan's statute does; rather, it would discriminate on the basis of the amount of benefits received by individual retirees.

489 U.S. at 816-17, 109 S.Ct. at 1508 (citation omitted).

The record in this case reflects that A.R.S. section 43-1022(2) exempts all Arizona state and local employees' contributions to retirement plans. Even those state and local employees who contribute from six to seven percent of their salaries and who are not subject to the social security system are exempted. The record also establishes that federal employees who participate in the Civil Service Retirement System, who contribute seven to eight percent of their salaries and nothing to the social security system, are nevertheless under Arizona law fully taxed on their Civil Service retirement contributions. If the rationale underpinning defendants' social security explanation for the discriminatory taxation were evenhandedly applied, some state employees would be subject to state income taxation. In other words, to sustain the statute under this argument, the retirement contributions of those state employees whose combined burden of social security and state retirement plan contributions was the same as that of federal employees should also be taxed. But, they are not.

Thus, the tax court correctly declared that former A.R.S. section 43-1022(2) violated the intergovernmental tax immunity doctrine and was unenforceable.

E. Tax Court's Refusal to Enjoin Continued Enforcement After Invalidating A.R.S. Section 43-1022(2)

The taxpayers also argue that the tax court erred in refusing to enjoin further enforcement of A.R.S. section 43-1022(2) once it had declared the statute violative of the intergovernmental tax immunity doctrine. They imply that in a case brought under 42 U.S.C. section 1983, the finding of a violation requires injunctive relief whether or not the traditional prerequisites for injunctive relief are present. The applicable case law does not support this view. The traditional requirements for obtaining injunctive relief, includeing making a showing of irreparable injury, also apply in section 1983 litigation. *Allee v. Medrano*, 416 U.S. 802, 814, 94 S.Ct. 2191, 2199-2200, 40 L.Ed.2d 566 (1974). *See, e.g., McCollum v. City of Powder Springs*, 720 F.Supp. 985 (N.D.Ga.1989).

Here, the tax court denied the taxpayers' request for injunctive relief. The court was influenced by its determination that only A.R.S. section 43-1022(2) [10] unconstitutionally discriminated against the taxpayers and that, in any event, the tax court's ruling was not retroacttive. As we have held, however, both A.R.S. sections 43-1001(2) and 43-1022(2) contravene the intergovernmental tax immunity doctrine. And, the United States Supreme Court recently held in *Harper* that, as a matter of federal law, *Davis* is to be applied retroactively. *Harper*, 509 U.S. at —, 113 S.Ct. at 2513. We accordingly vacate the tax court's ruling on the taxpayers' request for injunctive relief and remand for further consideration in light of our holding that A.R.S. section 43-1001(2) violates the doctrine of intergovernmental tax immunity.

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[10] This statute was repealed by the legislature after the court held it invalid. *See* note 6, *supra* at 1604-06.

F. Tax Court's Refusal to Declare Prospective Equality

The taxpayers further contend that the tax court erred in refusing to enjoin further enforcement and collection of Arizona income taxes on federal employees' retirement contributions or to declare that federal employees must in the future receive the same Arizona income tax exclusions as state and local employees. We disagree. Complying with the mandate of equal treatment may be accomplished by withdrawing benefits from the favored class as well as by extending benefits to the excluded class. *Davis*, 489 U.S. at 817-18, 109 S.Ct. at 1508-09. The Arizona Legislature has already complied in part with that mandate by amending A.R.S. section 43-1022 in 1989 and 1991 to eliminate any income tax exclusion for contributions to state or local retirement plans. It is free to do likewise as to the discriminatory effect of A.R.S. section 43-1001(2). The status of legislative efforts to comply with the mandate for equal treatment may be considered by the tax court on remand in connection with the taxpayers' application for injunctive relief.

G. Qualified Immunity of Individual Defendants on Section 1983 Damages Claim

The tax court granted summary judgment in favor of the individual defendants on the taxpayers' damage claims under 42 U.S.C. section 1983, holding that they were entitled as a matter of law to qualified immunity. The taxpayers challenge this ruling as error on three grounds. First, citing *Tower v. Glover*, 467 U.S. 914, 104 S.Ct. 2820, 81 L.Ed.2d 758 (1984), they contend that a defense of qualified immunity from a section 1983 damages claim may be recognized only if it existed under the common law in 1871, when section 1983 was first adopted, on behalf of the particular variety of official involved.

The taxpayers, however, misconstrue *Tower*. There the appellee was a public defender who sought dismissal of his

former client's damages complaint based solely on *absolute* immunity. The Supreme Court concluded from a review of the common law that public defenders have no such immunity for intentional misconduct of the type alleged. *Id.* at 916, 104 S.Ct. at 2822. The *Tower* opinion did not address whether a *qualified* immunity might be available in that case.

Furthermore, the United States Supreme Court has refuted the taxpayer's argument. Earlier, in *Harlow v. Fitzgerald*, 457 U.S. 800, 818, 102 S.Ct. 2727, 2738, 73 L.Ed.2d 396 (1982), the Court held that "government officials performing discretionary functions generally are shielded from liability for civil damages insofar as their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known." *See also Carroll v. Robinson*, 178 Ariz. 453, 456, 874 P.2d 1010, 1013 (App.1994) (qualified immunity protects state officers and employees from liability for good faith exercise of discretionary authority). In *Anderson v. Creighton*, 483 U.S. 635, 642-43, 107 S.Ct. 3034, 3040-41, 97 L.Ed.2d 523 (1987), the Court later emphasized that its doctrine of qualified immunity had been formulated for broad, general application, stating:

> Although we have in narrow circumstances provided officials with an absolute immunity . . . *we have been unwilling to complicate qualified immunity analysis by making the scope or extent of immunity turn on the precise nature of various officials' duties or the precise character of the particular rights alleged to have been violated.* An immunity that has as many variants as there are modes of official action and types of rights would not give conscientious officials that assurance of protection that it is the object of the doctrine to provide.

(Emphasis added) (citation omitted). *Cf. Dennis v. Sparks*, 449 U.S. 24, 101 S.Ct. 183, 66 L.Ed.2d 185 (1980) (rejecting absolute immunity claim as lacking basis in common law).

And, in *Buckley v. Fitzsimmons*, 509 U.S. 259, 113 S.Ct. 2606, 125 L.Ed.2d 209 (1993), the Court made it even clearer that reference to the status of the common law around 1871 is associated with claims of absolute immunity, rather than qualified immunity.

The taxpayers have cited no authority in support of their contention that even qualified immunity from section 1983 damages liability must find its roots in the common law of the late 19th century. Our independent research also reveals none. Thus, the individual defendants are entitled to assert the defense of qualified immunity.

The taxpayers' next contention is founded on the established principle that section 1983 qualified immunity from damages liability for official acts extends only to those acts that are truly discretionary. *See Westfall v. Erwin*, 484 U.S. 292, 108 S.Ct. 580, 98 L.Ed.2d 619 (1988). They assert that the individual defendants argued below that they lacked discretion "to do other than violate federal law." The taxpayers urge that the individual defendants thereby foreclosed themselves from invoking an immunity that presupposes their acts were discretionary. We disagree.

The individual defendants took the position below that they had no discretion other than to enforce the law. In our view, their determination of what law bound them in the exercise of their official duties, and what it required them to do, was necessarily discretionary. This is so even though the individual defendants viewed themselves as lacking discretion to decline to follow the law once they determined what it required. The individual defendants were thus entitled to invoke the defense of qualified immunity in response to the taxpayers' damages claims.

The taxpayers further contend:

> When *Davis* was announced in 1989, the individual defendants had actual knowledge that their conduct was

> illegal. They knew that federal law mandated equality in State taxation, yet they enforced a tax system which they knew was inherently unequal. Officials with knowledge that the laws they enforce are invalid have no right to assert a qualified immunity defense.

But, the principal case on which they rely, *Anderson v. Creighton*, 483 U.S. 635, 107 S.Ct. 3034, 97 L.Ed.2d 523 (1987), undermines their contention. Speaking for the Court in *Anderson*, Justice Scalia stated:

> [W]hether an official protected by qualified immunity may be held personally liable for an allegedly unlawful official action generally turns on the "objective legal reasonableness" of the action, assessed in light of the legal rules that were "clearly established" at the time it was taken.
>
> The operation of this standard, however, depends substantially upon the level of generality at which the relevant "legal rule" is to be identified. For example, the right to due process of law is quite clearly established by the Due Process Clause, and thus there is a sense in which any action that violates that Clause (no matter how unclear it may be that the particular action is a violation) violates a clearly established right. Much the same could be said of any other constitutional or statutory violation. But if the test of "clearly established law" were to be applied at this level of generality, it would bear no relationship to the "objective legal reasonableness" that is the touchstone of *Harlow*. Plaintiffs would be able to convert the rule of qualified immunity that our cases plainly establish into a rule of virtually unqualified liability simply by alleging violation of extremely abstract rights. . . . It should not be surprising, therefore, that our cases establish that the right the official is alleged to have violated must have been "clearly established" in a more particularized, and

> hence more relevant, sense: The contours of the right must be sufficiently clear that a reasonable official would understand that what he is doing violates that right. This is not to say that an official action is protected by qualified immunity unless the very action in question has previously been held unlawful; but it is to say that in the light of pre-existing law the unlawfulness must be apparent.

483 U.S. at 639-40, 107 S.Ct. at 3038-39 (citations omitted).

It is true, as the taxpayers point out, that since 1939 it has been settled that states may impose only nondiscriminatory taxes on the compensation of United States employees and that nothing has changed to render that principle unclear. But the retroactivity of *Davis*, even on facts closely similar to those before the *Davis* Court, remained unsettled until *Harper*. Similarly, the application of 4 U.S.C. section 111 to employee retirement plan contributions cannot be said to have been "clearly established law" until now. The tax court correctly granted summary judgment for the individual defendants on the taxpayers' section 1983 damages claim.

H. Attorneys' Fees and Costs on Appeal

The taxpayers request attorneys' fees and costs on appeal. Attorneys' fees and costs are properly awarded under A.R.S. section 12-348 (1992) and not as a percentage of the common fund. Thus, upon compliance with Rule 21, Arizona Rules of Civil Appellate Procedure, we award attorneys' fees and costs to the taxpayers pursuant to section 12-348.

IV. CONCLUSION

Because of our resolution of the dispositive issues on this appeal, we need not consider: (1) whether the tax court erred in certifying a taxpayer class; [11] (2) whether the tax court erred in adjudicating the existence of subclasses in the taxpayer class; (3) whether five subclasses are necessary to allocate the appropriate amount of refund if a retroactive remedy is provided; (4) whether the tax court erred in failing to award the taxpayer class a refund of past Arizona income tax overpayments; (5) whether the state was judicially precluded from asserting that the taxpayer class has no right to a refund; or (6) the extent to which, if at all, social security contributions must be considered in determining the appropriate amount of any retroactive refund.

Affirmed in part; reversed in part; vacated in part; remanded for further proceedings consistent with this opinion.

GRANT, P.J., concurs.

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[11] Appellees' cross-appeal challenged this certification only to the extent it was in aid of the taxpayers' claims for damages or refunds.

VOSS, *Judge*, concurring in part, dissenting in part.

I concur with the majority's opinion with one exception: I believe that section 1983 (§ 1983) challenges to state taxing schemes *are* subject to administrative exhaustion. I view this position as the logical extension of our holding in *Bohn* and one which is consistent with the approach taken by virtually all states that have addressed the question. *See, e.g., Neff v. New Mexico, Through Taxation and Revenue Department*, 116 N.M. 240, 861 P.2d 281 (App.1993); *Zarda v. Kansas*, 250 Kan. 364, 826 P.2d 1365 (1992), *cert. denied*, 504 U.S. 973, 112 S.Ct. 2941, 119 L.Ed.2d 566 (1992); *Dean v. Kansas*, 250 Kan. 417, 826 P.2d 1372 (1992), *cert. denied sub nom., Zarda v. Kansas*, 504 U.S. 973, 112 S.Ct. 2941, 119 L.Ed.2d 566 (1992); *Boughton Trucking and Materials, Inc. v. County of Will*, 229 Ill.App.3d 576, 171 Ill.Dec. 299, 593 N.E.2d 1119 (1992); *Bancroft Information Group, Inc. v. Comptroller of the Treasury*, 91 Md.App. 100, 603 A.2d 1289 (1992); *Nutbrown v. Munn*, 311 Or. 328, 811 P.2d 131 (1991), *cert. denied*, 502 U.S. 1030, 112 S.Ct. 867, 116 L.Ed.2d 773 (1992); *Hogan v. Musolf*, 163 Wis.2d 1, 471 N.W.2d 216 (1991), *cert. denied*, 502 U.S. 1030, 112 S.Ct. 867, 116 L.Ed.2d 773 (1992).

I agree with the reasoning of the aforementioned cases because I believe that the U.S. Supreme Court's ruling in *McNary* excludes § 1983 challenges to state tax systems from the non-exhaustion rule of *Felder*. In *McNary*, the Court made taxpayer suits under § 1983, for all intents and purposes, the exclusive responsibility of state tribunals. The Court stated:

> [W]e hold that taxpayers are barred by the principle of comity from asserting § 1983 actions against the validity of state tax systems in federal courts. Such taxpayers must seek protection of their federal rights *by state remedies*, provided of course that those remedies are

> plain, adequate, and complete, and may ultimately seek review of the state decisions in this Court.

454 U.S. at 116, 102 S.Ct. at 186 (emphasis added) (footnote omitted). Thus, under *McNary*, taxpayers' § 1983 claims are to be fully adjudicated in state courts and thereafter review is to be sought from the U.S. Supreme Court. In light of this, taxpayer suits under § 1983 are arguably no different than any other tax claims (whether based on state law, federal law, or the Constitution), all of which even the majority agrees are subject to the exhaustion requirement under *Bohn*. 174 Ariz. at 250, 848 P.2d at 335 (exhaustion of administrative remedies is not optional even if constitutional doctrines cannot be applied by the Department). Therefore, I would require administrative exhaustion for all taxpayer claims.

The majority, however, finds the cases that have taken this approach unpersuasive (particularly *Hogan* and *Nutbrown*) and cites *Murtagh*, 535 Pa. 50, 634 A.2d 179, as announcing the better reasoned rule. The Pennsylvania Supreme Court in *Murtagh* reached its result based on the conclusion that "the principle of comity that causes a federal court to refrain from exercising jurisdiction over section 1983 tax . . . cases has no relevance to [such cases] in state court. . . ." *Id.* at 185. I disagree. In *McNary*, the Court agreed 9-0 in the judgment, but was divided 5-4 as to the basis for that judgment. The majority based its decision on principles of comity while the concurring minority preferred to apply the exhaustion doctrine. The one thing upon which all of the Justices in *McNary* agreed, however, was that special, obvious reasons existed justifying the policy of federal noninterference with state tax collection and administration. The Court stated:

> If federal declaratory relief were available to test state tax assessments, state tax administration might be thrown into disarray, and taxpayers might escape the ordinary procedural requirements imposed by state law. . . . Moreover, federal constitutional issues are

> likely to turn on questions of state tax law, which, like issues of state regulatory law, are more properly heard in the state courts.

McNary, 454 U.S. at 108-09 n. 6, 102 S.Ct. at 182 n. 6; *Id.* at 137-38 n. 27, 102 S.Ct. at 197 n. 27 (Brennan, J., concurring in the judgment) (quoting *Perez v. Ledesma*, 401 U.S. 82, 128 n. 17, 91 S.Ct. 674, 699 n. 17, 27 L.Ed.2d 701 (1971) (Brennan, J., concurring in part, dissenting in part)). I believe that these reasons are equally relevant and applicable to state court interference in the administrative review of tax claims. As the Wisconsin Supreme Court noted in *Hogan*:

> It would be no less disruptive of the state's internal economy and administrative tax procedures for a state court to act under sec. 1983 and suspend the usual tax collection and refund procedures of the state than it would be for a federal court to do so. In addition, regardless of which court interferes with the state's fiscal operations, tax officials would be improperly denied the opportunity to rectify any alleged impropriety before being subject to a sec. 1983 action.

471 N.W.2d at 222.

The majority, however, contends that exempting § 1983 claims from the exhaustion requirement is proper and necessary because: (1) *McNary* does not apply where administrative remedies are inadequate; (2) states that require exhaustion for § 1983 claims, do so on the basis of explicit language which is lacking in our revised statutes; (3) *Nutbrown* and *Hogan* are inapplicable and/or poorly reasoned; (4) there is no valid reason to create an exception to *Zeigler;* and (5) permitting taxpayers to forego the administrative process in bringing their § 1983 claims will reduce inconvenience, inefficiency, delay, and expense. I am not persuaded by any of these arguments and address each in turn.

The majority first finds *McNary* and the cases which rely on it inapplicable because the administrative remedies available to taxpayers in Arizona are not "adequate." In the majority's view, administrative remedies in Arizona are inadequate because the tax board lacks the ability to declare tax statutes unconstitutional or enjoin their enforcement. There are fundamental flaws in this reasoning. First, it is dichotomous to exempt § 1983 claims from exhaustion based on the tax board's inability to decide questions of constitutionality when we have already held that the board's inability provides no exemption for constitutional claims arising under sections other than § 1983. *See Bohn*, 174 Ariz. at 250, 848 P.2d at 335.

Similarly, it is illogical to deem the administrative claims process inadequate based on the tax board's inability to issue an injunction when even the courts are, as a general rule, denied that power by statute. A.R.S. § 42-124(B)(1) (1991) ("No injunction . . . may issue in an action in any court in this state . . . to prevent or enjoin the collection of any tax. . . ."). The only exception to this statute is where the court finds the taxing scheme unconstitutional [12] —a finding which the tax board cannot make. Thus, the tax board's inability to issue injunctions is simply a natural consequence of its inability to rule on the constitutionality of a tax. Since we do not excuse exhaustion based on the latter, it makes no sense to obviate the requirement based on the former when the two are so tightly intertwined.

But even if the majority is correct in deeming Arizona's administrative tax claim remedies inadequate on these bases,

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[12] The cases cited by the majority as examples of injunctive relief in tax cases are clearly the exception to this general restriction and are both based on findings that the taxing schemes at issue were unconstitutional. I read these cases as standing for the proposition that injunctions in tax claims are only appropriate when the tax system being challenged is unconstitutional.

the majority's holding that this inadequacy makes *McNary* and its progeny inapplicable to this case is simply wrong.[13] The majority errs in its assertion that "the *McNary* analysis required only that a taxpayer exhaust the state administrative procedures that are a precondition to suit in state court." *McNary* holds nothing of the kind. As quoted above, *McNary* holds that § 1983 challenges to state taxing systems are not to be entertained in federal courts *at all* unless "state remedies" are inadequate. By state remedies the Court clearly was not referring solely to administrative remedies as the majority suggests. The adequacy of state remedies under *McNary* is to be gauged by the entire range of administrative and judicial procedures available to claimants. As the Maryland Court of Special Appeals recognized, *McNary* "acknowledges the appropriateness of resolving § 1983 tax claims according to the procedures established by the states, including exhaustion of administrative remedies." *Bancroft Information*, 603 A.2d at 1296. Thus, I disagree with the majority focusing solely on the perceived shortcomings of the administrative process in their effort to make *McNary* inapplicable.

I also disagree with the majority's approach on this issue because it creates a bad precedent. Under the majority's holding, taxpayers in Arizona now have permission not only to ignore state administrative exhaustion requirements in bringing their § 1983 actions in state court, they also can persuasively argue that they are no longer barred by *McNary* from filing such claims directly in federal court because the Arizona Court of Appeals has deemed state tax remedies inadequate. I do not believe this is a desirable or correct result. The Court in *McNary* did not intend to give taxpayers

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[13] As for the majority's other objection to the applicability of *Hogan*, I agree that *Hogan*—insofar as it can be read as requiring complete appellate exhaustion of all state remedies prior to filing a § 1983 action—goes too far.

the ability to circumvent state court jurisdiction based on inadequacies in administrative remedies.

The majority also holds that we should exempt § 1983 claims from administrative exhaustion requirements because "[t]he rule of exhaustion . . . is usually applied [based on] an express statutory mandate [and] Arizona has no express statute requir[ing] exhaustion." I disagree. A.R.S. section 42-115 sets the period for claims for credit or refunds as four years (per section 42-113) and provides that failure to begin an action for refund or credit within the time specified by this section is a bar against recovery of taxes by the taxpayer. Similarly, section 42-122 requires a taxpayer to file a petition within ninety days setting forth the reasons why a hearing correction or redetermination should be granted. "If the taxpayer does not file a petition for hearing, correction or redetermination within the period provided by this section, the amount determined to be due becomes final at the expiration of the period." A.R.S. § 42-122(B) (1991). Furthermore, appeals of decisions of the department to the state board, once decided, become final after thirty days and "[f]ailure to bring the action [as an appeal in superior court] within thirty days constitutes a waiver of the protest and *a waiver of all claims against this state arising from illegality in the tax, penalties and interest so paid.*" A.R.S. § 42-124(B) (1991) (emphasis added). We have previously held that failure to comply with a similar statute acts as *res judicata* with regard to administrative findings and bars collateral attack via § 1983 in superior court. *See Gilbert v. Board of Medical Examiners*, 155 Ariz. 169, 745 P.2d 617 (App.1987). In light of that decision, I view these statutes as a sufficient mandate for administrative exhaustion.

The majority also relies on *Zeigler*, 162 Ariz. 77, 781 P.2d 54, to support its conclusion that exhaustion of administrative remedies should never apply to § 1983 actions. I do not read *Zeigler* and *Felder*—the case upon which *Zeigler* relies—so

broadly, especially in light of *McNary*. *McNary* clearly creates an exception to *Felder* and should be the basis for our making a similar exception to *Zeigler*.

As for the majority's contention that its decision will reduce "inconvenience, inefficiency, delay, and expense" I must simply ask: For whom? Clearly, this decision will not provide such benefits to state tax officials who now find themselves subject to being haled at any time into either state or federal court to answer taxpayers' § 1983 complaints. Nor will this decision make life any easier for our trial courts. Instead, they likely will be faced with having to assume the role of the tax board in reviewing refund claims under the guise of § 1983 without the benefit of any factual record having been created prior to the case coming before them. It is exactly for these reasons that other states have chosen to require administrative exhaustion. "[T]he policies which motivated the Court's decision in *McNary* are equally applicable to sec. 1983 actions in state court." *Hogan*, 471 N.W.2d at 222. I agree and would adopt a policy requiring administrative exhaustion for all tax claims in Arizona.

ORDER

The court has considered appellants' "Motion for Reconsideration and in the Alternative, Clarification of Limited Portions of Opinion," the response, and reply; appellees' "Motion for Reconsideration," the response, and reply; and appellants' application for award of attorneys' fees and costs, the objections to the award of attorneys' fees and costs, and the reply.

An error was made on page four of the opinion in the above-mentioned matter filed on September 13, 1994. On page four, paragraph six, we cited 26 U.S.C. section 414(h). The correct citation is 4 U.S.C. section 111.

We deny appellant's request, pursuant to the "private attorney general" doctrine, for attorneys' fees in excess of the statutory limit established in A.R.S. section 12-348 (1992). The "private attorney general" doctrine is designed to encourage public interest litigation. *Arnold v. Department of Health Servs.*, 160 Ariz. 593, 609, 775 P.2d 521, 537 (1989). The doctrine is inapplicable here because appellants sought only to recover money for themselves; they did not seek to advance the public interest. *Cf. Corley v. Arizona Bd. of Pardons & Paroles*, 160 Ariz. 611, 613, 775 P.2d 539, 541 (App.1989). In fact, the state may have to impose burdens on the general public to raise the money that may be needed to satisfy appellants' claims.

We deny appellants' request for attorneys' fees pursuant to 42 U.S.C. section 1988 because appellants failed to request such fees in the briefs. Rule 21(c), Rules of Civil Appellate Procedure, provides that when "attorneys' fees are claimed pursuant to statute . . . a request for allowance of attorneys' fees . . . shall be made in the briefs on appeal." This court has interpreted that language to require the identification of the statute under which attorneys' fees are sought. *See City of Phoenix v. Superior Court*, 144 Ariz. 172, 177, 696 P.2d 724, 729 (App.1985). There is a good reason for this. Identifying the statute under which fees are sought enables the opposing party to respond to the request and allows us to address the issue in our decision. Here, appellants made a bare request for attorneys' fees. Despite this procedural defect, we awarded appellants' attorneys' fees under A.R.S. section 12-348. Nevertheless, appellants waived their claim for attorneys' fees under section 1988 because they did not, in their briefs, identify that statute. Therefore,

> IT IS ORDERED granting the taxpayers' "Motion for Reconsideration and in the Alternative, Clarification of Limited Portions of Opinion," and correcting the opinion

as follows: Changing "26 U.S.C. section 414(h)" to "4 U.S.C. section 111"

IT IS FURTHER ORDERED granting appellants' attorneys' fees pursuant to A.R.S. section 12-348 in the amount of $20,000, plus costs.

IT IS FURTHER ORDERED denying attorneys' fees pursuant to section 1988 for failure to request such fees in the briefs.

IT IS FURTHER ORDERED, by majority decision with Judge Voss dissenting, that appellees' motion for reconsideration is denied.

APPENDIX H

DARRELL F. SMITH, THE ATTORNEY GENERAL
STATE CAPITOL
PHOENIX, ARIZONA

July 21, 1967

DEPARTMENT OF LAW OPINION NO. 67-19 (R-87)

REQUESTED BY:	L. Waldo DeWitt, Chairman STATE TAX COMMISSION OF ARIZONA
QUESTION:	Are contributions by state employees to the Public Employee's Retirement Fund deductible in arriving at the net income subject to income taxation by the State of Arizona?
ANSWER:	Yes.

The question of taxation of employee contributions under the Arizona State Income Tax is a matter of statutory construction. The statute in question is A.R.S. § 38-762 which provides as follows:

> "The benefits, annuities and pensions, the employee and employer contributions and the securities in the several funds provided for in this article shall be exempt from state, county and municipal taxes, shall not be subject to execution or attachment and shall be nonassignable except as specifically provided in this article."

There are no decisions by the appellate courts construing this statute; however, there are two Attorney General opinions on this subject. In Attorney General Opinion No. 51-88 dated March 18, 1951, § 12-827 of the Arizona Code of 1939 was construed. This provision was substantially the same as A.R.S. § 12-858 in providing for exemption from

state taxation of employee contributions to the retirement fund. In 1955, the same question was answered in respect to the present statute in Attorney General Opinion No. 55-59. The position taken in both of these Attorney General opinions was that under the statute employee contributions were exempt from state income taxation.

The argument can be made that A.R.S. § 38-762 is not applicable because that income tax act taxes income rather than employee contributions. The problem with that argument is that it leaves us with nothing to explain the legislative purpose in respect to the language of A.R.S. § 38-762 pertaining to employee contributions. The income tax was in effect at the time that A.R.S. 38-762 was enacted into law and in the absence of a specific statutory provision, amounts of employee contributions would be included in the base on which the income tax was computed, just as social security contributions of the employee are included in that base. Presumably the words referring to employee contributions were used in the statue for a purpose. In construing statutory language, it is the court's duty to give meaning to all of the words used if it is possible to do so reasonably. *Cyr & Evans Contracting Co. v. Graham*, 2 Ariz. App. 196, 201, 407 P.2d 385. The presumption is that the Legislature did not intend to do a futile thing by including a provision which is not operative. *City of Mesa v. Killingsworth*, 96 Ariz. 290, 295, 394 P.2d 410. Under these circumstances, the previous construction of this language by the Attorney General is reasonable.

It is a general rule of law in Arizona that while administrative interpretation is not binding where long continued and in cases of ambiguity the courts will not adopt a different interpretation. *Long v. Dick*, 87 Ariz. 25, 347 P.2d 581; *Jenney v. Arizona Express, Inc.*, 89 Ariz. 343, 362 P.2d 664. Because of this rule and because this construction of the statute has been followed for the past twelve years by those

who were charged with the administration of the statute, any change from such long-established practice in the taxation of employee contributions ought to be made by the Legislature.

It is the opinion of the Attorney General that under A.R.S. § 38-762 that portion of a state employee's income (and of employees of certain political subdivisions of the state) which is transferred to the Public Employee's Retirement Fund is exempt from state income taxation and should not be included in determining the amount of such person's gross income for purposes of the Arizona State Income Tax.

Respectfully submitted,

/s/
DARRELL F. SMITH
The Attorney General

DFS:cah

APPENDIX I

PERTINENT PROVISIONS OF ARIZONA PENSION LAWS

1. ARIZONA STATE RETIREMENT SYSTEM AND PLAN

(consolidated in 1995 as the Arizona State Retirement System)

Statutes prior to *Davis v. Michigan*

§ 38-762 Exemptions from execution, attachment and taxation; exception; state retirement system; city retirement system or plan

(A) The benefits, annuities and pensions, the employee and employer contributions and the securities in the system's accounts provided for in this article and in any retirement system or plan established by a city shall be exempt from state, county and municipal taxes, shall not be subject to execution or attachment and shall be nonassignable, provided the city retirement system or plan was established by the city before January 31, 1954 pursuant to the charter of such city and such system or plan has been in operation continuously from on or before December 31, 1954 to the effective date of this section. Contributions that are withdrawn after December 31, 1974 by a public officer or employee from the accounts of the system or from the accounts of a retirement system or plan established by any such city and not received as benefits therefrom shall be subject to tax.

§ 38-781.22 Exemptions from execution, attachment and taxation; exception

(A) The benefits, annuities and pensions, the employee and employer contributions and the securities in the plan's accounts provided for in this article shall be exempt from state, county and municipal income taxes, shall not be subject to execution or attachment and shall be nonassignable except as specifically provided in this article. Contributions that are withdrawn after December 31, 1974 by a public officer or employee from the accounts of the plan and not received as benefits therefrom shall be subject to such tax.

Source: 1989 Ariz. Legis. Serv. 312 (West)

Statutes after amendment for *Davis v. Michigan*

§ 38-762 Exemptions from execution, attachment and taxation; exception; state retirement system; city retirement system or plan

(A) The benefits, annuities and pensions, the employee and employer contributions and the securities in the system's accounts provided for in this article and in any retirement system or plan established by a city shall not be subject to execution or attachment and shall be nonassignable, and the securities in the system's or plan's accounts are exempt from state, county and municipal taxes, provided the city retirement system or plan was established by the city before January 31, 1954 pursuant to the charter of such city and such system or plan has been in operation continuously from on or before December 31, 1954 to the effective date of this section. Contributions that are withdrawn after December 31, 1974 by a public officer or employee from the accounts of the system or from the accounts of a

retirement system or plan established by any such city and not received as benefits therefrom and benefits, annuities and pensions received by a public officer or employee from such a system after December 31, 1988 shall be subject to tax pursuant to title 43.

§ 38-781.22 Exemptions from execution, attachment and taxation; exception

(A) The benefits, annuities and pensions, the employee and employer contributions and the securities in the plan's accounts provided for in this article shall not be subject to execution or attachment and shall be nonassignable except as specifically provided in this article. The employee and employer contributions and the securities in the plan's accounts are exempt from state, county and municipal income taxes. Contributions that are withdrawn after December 31, 1974 by a public officer or employee from the accounts of the plan and not received as benefits therefrom and benefits, annuities and pensions received by a public officer or employee from the plan after December 31, 1988 shall be subject to tax pursuant to title 43.

Source: 1989 Ariz. Legis. Serv. 312 (West)

Statute after the consolidation of System and Plan effected by Laws 1995, Ch. 32

§ 38-792 Exemptions from execution, attachment and taxation; exception

(A) The benefits and annuities, the member and employer contributions and the securities in ASRS accounts provided for in this article are not subject to execution or attachment and are nonassignable except as specifically provided in this article. The

member and employer contributions and the securities in ASRS accounts are exempt from state, county and municipal income taxes. Contributions that are withdrawn after December 31, 1974 by a public officer or employee from the accounts of ASRS and that are not received as benefits from ASRS and benefits and annuities received by a public officer or employee from ASRS after December 31, 1988 are subject to tax pursuant to title 43.

Source: Arizona Revised Statutes Annot. (West 2001)

2. ELECTED OFFICIALS' RETIREMENT PLAN

Statute prior to *Davis v. Michigan*

§ 38-811 Exemption of contributions and benefits from taxation; exception

The benefits, annuities and pensions, the member and employer contributions and the securities in the fund are exempt from state, county and municipal taxes, except that contributions that are made and subsequently withdrawn after December 31, 1974 by a member from the accounts of the plan and are not received as benefits from the plan are subject to state taxes.

Source: Laws 1985, Ch. 309, Sec. 4

Statute after amendment for *Davis v. Michigan*

§ 38-811 Taxation of benefits; exemption of contributions and securities

The member and employer contributions and the securities in the fund are exempt from state, county and municipal taxes. Member and employer contributions that are made to and subsequently withdrawn from the fund after December 31, 1974 by a member from the accounts of the plan and are not received as benefits from the plan and benefits, annuities and

pensions received by a member from the plan after December 31, 1988 are subject to state taxes pursuant to title 43.

Source: Arizona Revised Statutes Annot. (West 2001)

3. PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM

Statute prior to *Davis v. Michigan*

§ 38-852 Exemption of benefits from taxation

The benefits, annuities and pensions, the employee and employer contributions and the securities in the several funds provided for in this article shall be exempt from state, county and municipal taxes.

Source: Laws 1968, Ch. 85, Sec. 1

Statute after amendment for *Davis v. Michigan*

§ 38-852 Taxation of benefits; exemption of contributions and securities

The employee and employer contributions and the securities in the several funds provided for in this article shall be exempt from state, county and municipal taxes. Employee and employer contributions that are withdrawn from the system after December 31, 1974 by a public officer or employee from the accounts of the system and not received as benefits therefrom and benefits, annuities and pensions received by a public officer or employee of the system after December 31, 1988 shall be subject to tax pursuant to title 43.

Source: Laws 1989, Ch. 312, Sec. 9

Statute after amendment for *Kerr* decision in 1991

§ 38-852 Taxation of benefits; exemption of contributions and securities

The employer contributions and the securities in the several funds provided for in this article shall be exempt from state, county and municipal taxes. Employee and employer contributions that are withdrawn from the system after December 31, 1974 by a public officer or employee from the accounts of the system and not received as benefits therefrom and benefits, annuities and pensions received by a public officer or employee of the system after December 31, 1988 shall be subject to tax pursuant to title 43.

Source: Arizona Revised Statutes Annot. (West 2001)

4. CORRECTIONS OFFICER RETIREMENT PLAN

Statute prior to *Davis v. Michigan*

§ 38-896 Exemption of member contributions and pension from taxation; exception

The benefits, member and participating employer contributions and the assets of the fund are exempt from state, county and municipal taxes, except that member contributions withdrawn after December 31, 1974 and subsequently withdrawn from the fund other than as a pension are subject to those taxes.

Source: Laws 1986, Ch. 325, Sec. 1

Statute after amendment for *Davis v. Michigan*

§ 38-896 Taxation of pensions; exemption for contributions

The member and participating employer contributions and the assets of the fund are exempt from state, county and municipal taxes. Member contributions made to the fund after December 31, 1974 and subsequently withdrawn from

the fund as other than a pension and benefits and pensions received by a member from the fund after December 31, 1988 are subject to tax pursuant to title 43.

Source: Laws 1989, Ch. 312, Sec. 10

Statute after amendment for *Kerr* decision in 1991

§ 38-896 Taxation of pensions; exemption for contributions

The participating employer contributions and the assets of the fund are exempt from state, county and municipal taxes. Member contributions made to the fund after December 31, 1974 and subsequently withdrawn from the fund as other than a pension and benefits and pensions received by a member from the fund after December 31, 1988 are subject to tax pursuant to Title 43.

Source: Arizona Revised Statutes Annot. (West 2001)

APPENDIX J

STATES ADOPTING INTERNAL REVENUE CODE FOR STATE TAX PURPOSES

States	Individual Income Tax Statutes	Corporate Income Tax Statutes
Alabama	Ala. Code § 40-18-1.1(b)	Ala. Code § 40-18-1.1(b)
Alaska	Not applicable	Alaska Stat. §43.20.021(a)
Arizona	Ariz. Rev. Stat. §§ 42-1001 and 43-1004.	Ariz. Rev. Stat. § 42-1001
California	Cal Rev. & Tax Code §§ 17071 and 17131-17155	Cal. Rev. & Tax Code § 24271
Colorado	Colo. Rev. Stat. § 39-22-104	Colo. Rev. Stat. §§ 39-22-110, 39-22-113 and 39-22-304
Connecticut	Conn. Gen. Stat. § 12-701	Conn. Gen. Stat. § 12-213
Delaware	Del. Code Ann. tit. 30, §§ 1105 and 1106	Del. Code Ann. tit. 30, § 1903
Florida	Not applicable	Fla. Stat. ch. 220.12 and 220.13
Georgia	Ga. Code Ann. § 48-7-27(a)	Ga. Code Ann. §§ 48-1-2 and 48-7-21
Hawaii	Haw. Rev. Stat. § 235-2.4	Haw. Rev. Stat. § 253-2.4
Idaho	Idaho Code §§ 63-3004 and 63-3022	Idaho Code § 63-3004
Illinois	35 Ill. Comp. Stat. 5/203	35 Ill. Comp. Stat. 5/201
Indiana	Ind. Code §§ 6-3-1-3.5 and 6-3-1-11	Ind. Code §§ 6-3-1-3.5 and 6-3-1-11

Iowa	Iowa Code § 422.7	Iowa Code § 422.35
Kansas	Kan. Stat. Ann. §§ 79-32,117 and 79-32,117(b)	Kan. Stat. Ann. § 79-32,138
Kentucky	Ky. Rev. Stat. Ann. § 141.010	Ky. Rev. Stat. Ann. § 141-010(2)
Louisiana	La. Rev. Stat. Ann. § 47:293(6)(a)(iv)	La. Rev. Stat. Ann. §§ 47:287.61 and 47:287.67
Maine	Me. Rev. Stat. Ann. tit 36, §§ 5121 and 5122	Me. Rev. Stat. Ann. tit. 36, § 5200-A
Maryland	Md. Code Ann., Tax-Gen. §§ 10-101, 10-203 and 10-204	Md. Code Ann., Tax-Gen. §§ 10-301 and 10-310
Massachusetts	Mass. Gen. Laws ch.62, §§ 1(c) and 1,2(a)	Mass. Gen. Laws ch. 69, § 30
Michigan	Mich. Comp. Laws §§ 206.12 and 206.30	Mich. Comp. Laws § 208.3
Minnesota	Minn. Stat. § 290.01	Minn. Stat. § 290.01(19)
Missouri	Mo. Rev. Stat. § 143.121	Mo. Rev. Stat. § 143.431
Montana	Mont. Code Ann.§§ 15-30-101 and 15-30-111	Mont. Code Ann. § 15-31-113
Nebraska	Neb. Rev. Stat. § 77-2716	Neb. Rev. Stat. §§ 77-2714 and 77-2734.04
New Hampshire	Not applicable	N.H. Rev. Stat. Ann. § 77-A:1
New Jersey	Not applicable	N.J. Stat. Ann. § 54:10A-4(k); N.J. Reg. 18:7-5.1
New Mexico	N.M. Stat. Ann. § 7-2-2(A)	N.M. Stat. Ann. § 7-2A(2)(c)

New [illegible]	N.Y. Tax Law §§ 611 and 612	N.Y. Tax Law § 208(9)(a)
North Carolina	N.C. Gen. Stat. § 105-134.5	N.C. Gen. Stat. § 105-228.90(b)(1)
North Dakota	N.D. Cent. Code §§ 57-38-01 and 57-38.01.2	N.D. Cent. Code §§ 57-38-01 and 57-38-01.3
Ohio	Ohio Rev. Code Ann. § 5747.01	Ohio Rev. Code Ann. § 5733.04(I)
Oklahoma	Okla. Stat. tit.68, § 2358	Okla. Stat. tit. 68, §§ 2353 and 2358
Oregon	Or. Rev. Stat. §§ 316.048 and 316.680	Or. Rev. Stat. §§ 314.011, 317.010, 317.018 and 317.259
Pennsylvania	Not applicable	72 Pa. Cons. Stat. § 7401
Rhode Island	R.I. Gen. Laws § 40-30-12	R.I. Gen. Laws § 44-11-11
South Carolina	S.C. Code Ann. §§ 12-6-40, and 12-6-560	S.C. Code Ann. §§ 12-6-40 and 12-6-580
Tennessee	Not applicable	Tenn. Code Ann. § 67-4-2006
Utah	Utah Code Ann. § 59-10-112	Utah Code Ann. § 59-7-101
Vermont	Vt. Stat. Ann. tit. 32, §§ 5811 and 5823	Vt. Stat. Ann. tit. 32, § 5811
Virginia	Va. Code Ann. § 58.1-322	Va. Code Ann. § 58.1-402
West Virginia	W. Va. Code § 11-21-12	W. Va. Code § 11-24-6
Wisconsin	Wis Stat. § 71.01(6)(p)	Wis. Stat. § 71.26

STATES THAT DISCRIMINATORILY TAX FEDERAL EMPLOYEES' MANDATORY CONTRIBUTIONS

States	Provisions Adopting Internal Revenue Code	State Pick-Up Provisions
Alabama	Ala. Code § 40-18-1.1(b)	Ala. Code §§12-18-5(c) and §36-27-24(b)
Arizona	Ariz. Rev. Stat. §§ 42-1001 and 43-1004.	Ariz. Rev. Stat. §§38-843. 01 and 38-892
California	Cal. Rev. & Tax Code §§ 17071 and 17131-17155	Cal. Educ. Code §22904 Cal. Gov't Code §§9358 .01, 20636, and 22960. 61
Colorado	Colo. Rev. Stat. § 39-22-104	Colo. Rev. Stat. §§22-64-105(2), 24-51-403, and §31-31-402(1)
Connecticut	Conn. Gen. Stat. § 12-701	Conn. Gen. Stat. §§7-440a and 10-183kk
Delaware	Del. Code Ann. tit. 30, §§ 1105 and 1106	Del. Code Ann. tit. 11, §§8330(a), 8394(a), 8844 (a), Del. Code Ann. tit. 29, §§5547(a), 5594(a), and 5618(a)
Hawaii	Haw. Rev. Stat. § 235-2.4	Haw. Rev. Stat. § 88-46 (b) and 88-59(1)
Idaho	Idaho Code §§ 63-3004 and 63-3022	Idaho Code §59-1332(1)
Illinois	35 Ill. Comp. Stat. 5/203	40 Ill. Comp. Stat. 5/16-154(a)

Indiana	Ind. Code §§ 6-3-1-3.5 and 6-3-1-11	Ind. Code §5-10.2-3-2(d)
Iowa	Iowa Code § 422.7	Iowa Code §§294-10A and 97B.11A
Louisiana	La. Rev. Stat. Ann. § 47:293(6)(a)(iv)	La. Rev. Stat. Ann. §§502.3(A)(2) and 927(A)
Michigan	Mich. Comp. Laws §§ 206.12 and 206. 30	Mich. Comp. Laws §38. 1343a(1)
Minnesota	Minn. Stat. § 290.01	Minn. Stat. §356.62(a)
Missouri	Mo. Rev. Stat. § 143.121	Mo. Rev. Stat §50.1040(2)
Montana	Mont. Code Ann. §§ 15-30-101 and 15-30-111	Mont. Code Ann. §19-8-502(a)
Nebraska	Neb. Rev. Stat. § 77-2716	Neb. Rev. Stat. §§18-1749, 23-2307, 79-958(3), 16-1005(2), 16-1024(2), 2-1608, 81-2017(2), 84-1325(2), 23-2323.01, 79-9,113(2), 14-2111(2), 23-1118(4), and 24-703(10)
New Mexico	N.M. Stat. Ann. § 7-2-2(A)	N.M. Stat. Ann. §§22-11-21.3(A), 10-11-125, 10-12C-10(B), and 10-12B-10(B)
North Carolina	N.C. Gen. Stat. § 105-134. 5	N.C. Gen. Stat. §§120-4.19, 128-30, and 135-68
North Dakota	N.D. Cent. Code §§ 57-38-01 and 57-38.01.2	N.D. Cent. Code §54-52-05

Ohio	Ohio Rev. Code Ann.§ 5747.01	1986 Ohio Op. 86-025, 1984 Ohio Op. 84-058, and 1984 Ohio Op. 84036
Oklahoma	Okla. Stat. tit.68, § 2358	Okla. Stat. tit. 11, §§11-49-122(A) and 11-50-110(B) Okla. Stat. tit.20, §20-1103.3(B) Okla. Stat. tit. 47, §47-2-304(C) Okla. Stat. tit. 74, §74-919.1(3) and 74-920A(C)
Oregon	Or. Rev. Stat. §§ 316.048 and 316.680	Or. Rev. Stat. §105-020-0015(1)
Rhode Island	R.I. Gen. Laws § 40-30-12	R.I. Gen. Laws §§36-9-39(e)(iii), 36-9-42(e)(3), and 36-9-44(e)(3)
South Carolina	S.C. Code Ann. §§ 12-6-40, and 12-6-560	S.C. Code Ann. §§9-1-1020, 9-1-1160, 9-8-130(4), 9-9-120(6), 9-11-210(11), and 9-20-50
Utah	Utah Code Ann. § 59-10-112	Utah Code Ann. §§49-12-301(3)(a), 49-14-301(3)(a), and 49-16-301(3)(a)
Vermont	Vt. Stat. Ann. tit. 32, §§ 5811 and 5823	Vt. Stat. Ann. tit. 24, §5064(b)(3)(B) Vt. Stat. Ann. tit. 16, §1944(h) Vt. Stat. Ann. tit. 3, §473(f)
Virginia	Va. Code Ann. § 58.1-322	Va. Code Ann. §51.1-144(G)
Wisconsin	Wis Stat. § 71.01 (6)(p)	Wis Stat. §40.05(1)(b)

Supreme Court, U.S.
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No. 03-1495

In The Supreme Court of the United States

SUSAN MORAN, et al.,

Petitioners,

v.

J. ELLIOTT HIBBS, et al.,

Respondents.

On Petition For Writ Of Certiorari To The Supreme Court Of Arizona

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Arizona's income tax scheme uses federal adjusted gross income to compute Arizona income taxes. Federal adjusted gross income includes federal employees' mandatory retirement contributions, which are not picked up by federal employers. State employees' mandatory retirement contributions that are picked up by their employers, in contrast, are not included in federal adjusted gross income until the contributions are withdrawn or paid as retirement benefits. Does Arizona's income tax scheme violate the intergovernmental tax immunity doctrine in 4 U.S.C. § 111?

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents, the Director of the Arizona Department of Revenue, J. Elliott Hibbs, and the Arizona Department of Revenue (the State), respectfully request that this Court deny the Petition for Certiorari of Susan Moran, Steve Allen, and John Udall seeking review of the Arizona Supreme Court decision in this case.

STATEMENT OF THE CASE

Petitioners ask the Court to address whether Arizona's income tax scheme violates the intergovernmental tax immunity doctrine in 4 U.S.C. § 111. They claim that Arizona discriminates against federal employees because it adopts the Internal Revenue Code, which taxes federal employees' mandatory retirement contributions while deferring taxation of state and local employees' mandatory retirement contributions that are picked up by their employers. The Arizona Supreme Court unanimously held that the Arizona income tax scheme does not discriminate against federal employees because of their source of pay and therefore does not violate the intergovernmental tax immunity doctrine. *Kerr v. Killian,* 84 P.3d 446 (Ariz. 2004) (Pet. App. 1a-22a.)

Petitioners do not provide the Court with any reason to grant review. The Arizona decision is consistent with the Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989), and its other precedents concerning the intergovernmental tax immunity doctrine. As Petitioners acknowledge, many other States similarly

tax mandatory retirement contributions, yet the Arizona decision does not conflict with any other federal or state court decision.

Statutory Background.

In 1979, Arizona adopted federal adjusted gross income as the starting point for computing Arizona taxable income. 1978 Ariz. Sess. Laws, ch. 213, § 2. The current statute provides that "'Arizona gross income' . . . means the individual's federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code." Arizona Revised Statutes (A.R.S.) § 43-1001(2) (Supp. 2003). In 1979, the Arizona Legislature also amended Arizona income tax law to allow state and local employees to deduct mandatory retirement contributions from their adjusted gross income. 1978 Ariz. Sess. Laws, ch. 213, § 2 (codified at A.R.S. § 43-1022(2) (Supp. 1978)). At that time, Arizona also allowed persons to deduct all benefits received from mandatory state and local retirement plans. A.R.S. § 43-1022(3) (Supp. 1988).

In 1985, the Arizona Legislature authorized two of the state retirement plans (the Arizona State Retirement Plan [ASRS] and the Elected Officers Retirement Plan [EORP]) to "pick up" employee contributions to conform with the requirements of Internal Revenue Code (I.R.C.) § 414(h)(2). Section 414(h)(2) provides that if a state or local governmental employer pays (or "picks up") employee contributions to a retirement plan qualified under I.R.C. §§ 401(a) or 403(a), "the contributions so picked up shall be treated as employer contributions." Both contributions are taxed when the employee plan pays benefits to the

employee instead of when the contributions are made to the retirement plan. (Pet. App. at 3a, 7a.)

In 1989, this Court held that Michigan violated the intergovernmental tax immunity doctrine by taxing federal retirees' retirement benefits while exempting state retirees' retirement benefits. *Davis*, 489 U.S. at 817. The Arizona Legislature responded to *Davis* by amending A.R.S. § 43-1022(3) to remove the deduction for benefits received from state and local retirement plans. 1989 Ariz. Sess. Laws, ch. 312, § 12. The Arizona Legislature also amended A.R.S. § 43-1022 to eliminate the deduction for mandatory contributions to ASRS, EORP, and county and city retirement plans. *Id.* In 1991, the Legislature eliminated the deduction for mandatory contributions to two other state retirement plans, the Correctional Officer Retirement Plan (CORP) and the Public Safety Personnel Retirement System (PSPRS). 1991 Ariz. Sess. Laws, ch. 155, § 8.

In 1999, the Legislature authorized PSPRS to pick up employee contributions (1999 Ariz. Sess. Laws, ch. 50, § 4 & ch. 327, § 22), and PSPRS elected to pick them up in 2000 (Pet. App. 7a). In 2000, CORP also elected to pick up employee contributions. (Pet. App. 7a.)[1] Thus, from 1989 to 2000, the state and local employees in CORP and PSPRS paid taxes on their mandatory contributions to these plans. *(Id.* at 8a.)

Federal employees are covered by retirement plans that Congress has adopted. Before 1987, federal employees participated in the Civil Service Retirement System (CSRS). (I.R.A. 140.) Employee contributions to the CSRS

[1] The Legislature authorized CORP to pick up employee contributions in 1986. 1986 Ariz. Sess. Laws, ch. 325, § 1.

are included in the employee's federal adjusted gross income and are subject to federal[2] and to Arizona[3] income tax at the time of the contribution.

In 1986, Congress adopted the Federal Employees Retirement System (FERS) to replace CSRS for employees hired after 1983. 5 U.S.C. § 8402, *added by* Pub. L. No. 99-335, title I, § 101(a), 100 Stat. 521 (1986). FERS is a three-tier plan consisting of Social Security benefits, a basic benefit plan (annuity), and a thrift savings plan. 5 U.S.C. § 8403 (Social Security); 5 U.S.C. § 8415 (basic annuity); 5 U.S.C. § 8437 (thrift savings plan). Employee contributions to the basic benefit plan are included in the employee's federal adjusted gross income and are subject to federal[4] and to Arizona[5] income tax. Federal employee contributions in the thrift savings plan are not included in federal adjusted gross income and therefore are not subject to federal[6] or Arizona[7] income tax until the contributions are withdrawn or paid as retirement benefits.

Proceedings Below.

Petitioners, current federal employees and Arizona taxpayers, initiated this litigation in 1989 as an administrative action requesting tax refunds. Although the case originally involved claims for refunds for taxes paid on federal retirement benefits and contributions to federal

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[2] 5 U.S.C. § 8334(b).

[3] A.R.S. §§ 43-1001(2) to -1099.

[4] 5 U.S.C. § 8422(b).

[5] A.R.S. §§ 43-1001(2) to -1099.

[6] 5 U.S.C. § 8440(a)(2).

[7] A.R.S. §§ 43-1001(2) to -1099.

retirement plans before 1991, current and former federal employees, including Petitioners, received refunds for Arizona taxes paid on retirement benefits and contributions before 1991. (Pet. App. at 10a [noting that Arizona's Governor directed the Arizona Department of Revenue "to make refunds for the tax years from 1985 to 1990 to all taxpayers who had filed timely refund claims"].) In addition to the question of class certification that has been remanded to the trial court and is not at issue here, all that remains is the issue presented here—i.e., Petitioners' claim that they are entitled to refunds for taxes paid on mandatory retirement contributions after 1990. (Pet. App. at 12a.)

As to that issue, the Arizona Court of Appeals initially held that "Arizona's income taxing scheme applicable to tax years 1991 to the present does not violate 4 U.S.C. § 111 to the extent it taxes federal employees' mandatory contributions to retirement plans, but not those of certain state and local employees." *Kerr v. Killian*, 32 P.3d 408, 417 (Ariz. App. 2001) (*Kerr IV*)[8] (Pet. App. at 69a.) The court reasoned that "Arizona's taxing scheme . . . distinguishes not between state and federal employees, but rather between all those whose employers make or pick up their mandatory

[8] There are three earlier published opinions that address either Petitioners' related 42 U.S.C. § 1983 litigation or another issue in Petitioners' refund litigation: *Kerr v. Waddell*, 899 P.2d 162 (Ariz. App. 1994) (Pet. App. 107a-153a) (*Kerr I*) (holding in Petitioners' 42 U.S.C. § 1983 case that Arizona's income tax scheme violated the intergovernmental tax immunity doctrine); *Kerr v. Waddell*, 916 P.2d 1173 (Ariz. App. 1996) (Pet. App. 88a-106a) (*Kerr II*) (dismissing Petitioners' 42 U.S.C. § 1983 claims for failure to exhaust administrative remedies and vacating *Kerr I*); and *Kerr v. Killian*, 3 P.3d 1133 (Ariz. App. 2000) (Pet. App. 74a-88a) (*Kerr III*) (addressing attorneys' fees issue in Petitioners' administrative refund action).

retirement contributions and all those whose employers do not." (Pet. App. at 63a).

The Arizona Court of Appeals reconsidered the holding in *Kerr IV* and found that it "sprang from a narrow, mistaken application of the literal language of 4 U.S.C. § 111." *Kerr v. Killian*, 65 P.3d 434, 440 (Ariz. App. 2003) (*Kerr V*) (Pet. App. at 36a). The court found that the practical effect of Arizona's taxing scheme was to require federal employees to pay Arizona income tax on their mandatory contributions to retirement plans while "effectively excusing most state and local governmental employees from paying such taxes on their own mandatory contributions to their corresponding state or local governmental retirement plans." (Pet. App. at 37a.) Because the court did not find any significant differences between the two classes of taxpayers, it held that Arizona's income tax scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine. (Pet. App. at 41a.)

The Arizona Supreme Court vacated the portion of the court of appeals amended opinion that held that "the application of [A.R.S.] § 43-1001(2) to [Petitioners] violated the intergovernmental tax immunity doctrine codified in § 111." (Pet. App. at 21a.)[9] The court found that A.R.S.

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[9] Petitioners erroneously assert in their Statement of the Case that the State's Petition for Review in the Arizona Supreme Court was "jurisdictionally untimely." (Pet. at 6.) The State filed its Petition for Review thirty days after the court of appeals issued its amended opinion. This filing was timely under Rule 23(a) of the Arizona Rules of Civil Appellate Procedure. The Arizona Supreme Court therefore denied Petitioner's Motion to Dismiss Petition for Review that raised the timeliness issue. Arizona Supreme Court Order of October 29, 2003. In any event, failure to file a timely petition for review is not jurisdictional. *See* Rule 5(b) of the Arizona Rules of Civil Appellate Procedure ("The time for doing any of the acts provided in these rules, by order of

(Continued on following page)

"§ 43-1001(2) contains no overt discrimination against any taxpayer because of the source of pay," noting that "[e]very Arizona taxpayer, whether employed by the federal government, the State, a political subdivision, or a private employer, begins with federal AGI [adjusted gross income] as the Arizona tax base." (Pet. App. at 16a.) The court also examined the "practical operation" of A.R.S. § 43-1001(2) as *Phillips Chemical Co. v. Dumas Independent School District*, 361 U.S. 376, 383 (1960), and *Barker v. Kansas*, 503 U.S. 594, 604-05 (1992), require. (Pet. App. 17a-18a.) The court concluded that the practical operation "does not require that federal employees be taxed differently than state employees with respect to mandatory retirement contributions" because (1) Arizona taxes state and local employees' contributions to retirement plans that have not been picked up by their employers the same as it treats federal employees' contributions to retirement plans; and (2) the distinction in the treatment of the contributions is not based on the source of the income but on "whether a particular governmental employer has voluntarily opted to pick up the employee contributions and treat them as employer contributions." (Pet. App. at 18a.)

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the court, or by any applicable statute, may be shortened or extended by the court upon stipulation or upon motion, for good cause shown, but the court may not shorten or extend the time for filing a notice of appeal.").

REASONS TO DENY THE PETITION

1. The Arizona Supreme Court Decision Does Not Conflict with Relevant Decisions of This Court.

Petitioners incorrectly argue that the Arizona Supreme Court decision is contrary to *Davis* and *Barker* and is inconsistent with this Court's other precedents. The Arizona Supreme Court correctly determined that A.R.S. § 43-1001(2), which adopts federal adjusted gross income as the starting point for computing Arizona taxes, does not facially discriminate against federal employees. Therefore, the decision is not contrary to *Davis* or *Barker*, which hold that such facial discrimination violates 4 U.S.C. § 111.[10] The Arizona Court further correctly determined that the practical operation of A.R.S. § 43-1001(2) does not require discriminatory treatment of federal employees. The decision therefore is consistent with the Court's precedents that requires lower courts to examine the practical operation of a challenged tax scheme to ascertain whether the tax scheme discriminates based on the source of the compensation or pay. The Court should therefore deny review.

a. Unlike the Tax Schemes in *Davis* and *Barker*, A.R.S. § 43-1001(2) Does Not Facially Discriminate Against Federal Employees.

In *Davis*, the Court held that Michigan's income tax scheme violated the intergovernmental tax immunity

[10] Section 111(a) provides: "The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation."

doctrine codified in 4 U.S.C. § 111. Michigan's Income Tax Act explicitly exempted from taxation the retirement benefits that Michigan and its political subdivisions paid, but levied an income tax on retirement benefits that all other employers, including the federal government, paid. 489 U.S. at 817. The Court noted that it was "undisputed that Michigan's tax system discriminate[d] in favor of retired state employees and against retired federal employees." *Id.* at 814. The Court therefore concluded without analysis that the discrimination would violate § 111 unless "'justified by significant differences between the two classes.'" *Id.* at 815-16 (quoting *Phillips Chemical Co.*, 361 U.S. at 383). The Court did not find that either of Michigan's proffered reasons justified its discriminatory treatment and held that the petitioner was entitled to a tax refund. *Id.* at 817.

Like the Michigan income tax scheme addressed in *Davis*, the Kansas income tax scheme challenged in *Barker* overtly discriminated against some federal retirees: "The State of Kansas taxes the benefits received from the United States by military retirees but does not tax the benefits received by retired state and local government employees." *Barker*, 503 U.S. at 596. The Court therefore only addressed the Kansas Supreme Court's determination that significant differences between military retirees and state and local government pensioners justified the discrimination. *Id.* at 598. The Court reversed because it found that the lower court based its determination that the discrimination was justified on an erroneous characterization of military retirement benefits as current compensation for reduced current services. *Id.* at 605.

The Arizona Supreme Court correctly noted that both *Davis* and *Barker* concerned income tax schemes that

facially discriminated against federal employees and that this Court therefore concluded in those cases that the challenged tax schemes discriminated because of the federal source of pay. (Pet. App. at 16a.) The Arizona court then correctly found that the Arizona income tax law challenged here, A.R.S. § 43-1001(2), which uses federal adjusted gross income to compute Arizona income taxes, is different from the tax schemes that *Davis* and *Barker* addressed: "A.R.S. § 43-1001(2) contains no overt discrimination against any taxpayer because of the source of the pay." (Pet. App. at 16a.)

Petitioners only obliquely address the Arizona court's distinction between the Arizona income tax scheme challenged here and the tax schemes in *Davis* and *Barker*. They argue that the court's "suggestion that Ariz. Rev. Stat. § 43-1001(2) (2004) contains no overt discrimination is untenable." (Pet. at 12 n.9.) But Petitioners do not point to any overt discrimination in the language of the statute and instead discuss what they claim is the tax provision's practical operation—i.e., "if a taxpayer is not an employee of the state or one of its local subdivisions, the employees cannot qualify for the favored treatment." *Id.* This Court rejected a similar argument in *Jefferson County v. Acker*, 527 U.S. 423, 442-43 (1999). It held that a facially nondiscriminatory Alabama occupational tax exempting those who held licenses under other state or county laws did not violate § 111, even though the plaintiff federal judges could never qualify for an exemption, because the tax did "not discriminate against federal judges in particular, or federal officeholders in general, based on the federal *source* of their pay or compensation." Because the Arizona decision correctly distinguished between the facial discrimination that the Court addressed in *Davis* and *Barker*

and the facially neutral statute at issue here, it is not contrary to those decisions.

b. The Practical Operation of A.R.S. § 43-1001(2) Does Not Require that Federal Employees Be Taxed Differently than State Employees with Respect to Mandatory Retirement Contributions.

Petitioners argue that the court below applied the wrong test by suggesting that "the intergovernmental doctrine applies only to statutes that discriminate on their face against a federal interest" and that the substance of the Arizona scheme violates the intergovernmental tax immunity doctrines under this Court's precedents. (Pet. at 12.) Petitioners are wrong as to both arguments.

In determining whether there is a violation of the intergovernmental tax immunity doctrine, the Court examines the "practical operation" of the challenged tax scheme. *Phillips*, 361 U.S. at 383; *see also Jefferson County*, 527 U.S. at 439 (to determine whether a tax fits within the allowance in § 111, the Court examines the "practical impact, not the State's name tag."). But examining the practical operation of the taxing scheme does not mean that any state tax that has a disparate impact on federal employees is invalid. Section 111 only prohibits taxation that discriminates "on the basis of the source" of the compensation. *Davis*, 489 U.S. at 817; *see also Jefferson County*, 527 U.S. at 442-43 (finding that the challenged tax did not discriminate against federal employees "based on the federal source of their pay or compensation").

Contrary to Petitioners' implication, the court below did not stop its analysis after it found that the Arizona scheme did not facially discriminate against federal employees. Instead, the court acknowledged that if there was no facial discrimination in § 43-1001(2), it must examine the "'practical operation' of the Arizona scheme." (Pet. App. at 17a [citing *Phillips*, 361 U.S. at 383].) Nor did the court ignore this Court's admonition in *Jefferson County* that courts must look past form to substance. The court correctly concluded that the practical operation of A.R.S. § 43-1001(2) "does not require that federal employees be taxed differently than state employees with respect to mandatory retirement contributions." (Pet. App. at 18a.) The court's conclusion was based on the Arizona statutes' neutral operation. The court first noted that "Arizona taxes the employee contributions of those state employees whose contributions have not been picked up by their employers in precisely the same fashion as it treats the employee contributions of federal employees." (Pet. App. 18a.)

Petitioners do not address the court's finding that the fact that many state and local government employees paid current state tax on mandatory retirement contributions indicates that the Arizona scheme is not a cloak for discrimination. Instead, they argue that the Legislature's failure to remove the exemption for retirement contributions from the statutes governing the ASRS and EORP retirement plans demonstrates its discriminatory intent, even though it removed the deductions from the income tax statutes. (Pet. at 13.) The lower court explained the Legislature's failure to remove these exemptions: "Presumably, the legislature did not remove the exemption of the member contributions in 1989 in light of the preexisting pick ups under § 414(h)(2) by ASRS and EORP." (Pet.

App. 7a n.6.) In addition, the timing of the Legislature's enactment of A.R.S. § 43-1001(2) and of the legislation authorizing ASRS and EORP to pick up employee contributions, both of which predate the *Davis* decision and the Legislature's reaction to it, undermine Petitioners' suggestion that A.R.S. § 43-1001(2) was a cloak for discrimination.

The lower court also found that the Arizona scheme was neutral in practical operation because nothing in the scheme "discriminates between taxpayers based on the federal or non-federal source of income; the distinction is instead based on whether a particular governmental employer has voluntarily opted to pick up the employee contributions and treat them as employer contributions." (Pet. App. at 18a.) This finding is consistent with the interpretation of § 111 in *Davis* and *Jefferson County*.

Petitioners argue that the lower court's rationale defies this Court's precedents because it requires Congress to cure the State's discrimination. (Pet. at 9.) Petitioners' argument misconstrues the lower court's rationale. The court correctly recognized that the federal government has always had the option to pick up employee contributions and that it can exercise that option at any time "through its legislative branch," but that it has not yet chosen to do so. (Pet. App. at 19a.) Instead, Congress has adopted FERS, a three-tiered plan that includes mandatory retirement contributions that are subject to tax at the time of the contribution but also gives federal employees the option of making deferred contributions to a thrift savings plan. Congress has apparently chosen the plan that suits the federal government's needs at this time instead of opting to pick up mandatory employee contributions. Thus, the Arizona Supreme Court correctly concluded that

Arizona's treatment of Petitioners' employee contributions is not a "necessary consequence of their federal status" and that it therefore does not violate the intergovernmental tax immunity doctrine. (Pet. App. 19a.)

Finally, Petitioners are wrong in arguing that the Arizona decision is inconsistent with *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), and *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992). *Memphis Bank* involved a facially discriminatory tax. Although the Tennessee business tax at issue there incorporated the federal adjusted gross income, the Tennessee statute added to the base "all income derived from obligations of states other than Tennessee." (Pet. App. 17a [citing *Memphis Bank*, 459 U.S. at 394 & n.3].) As the lower court noted, this resulted in express discrimination: "Because federal AGI already included obligations of the United States . . . , the Tennessee law thus provided an express exemption from taxation for income from bonds issued by the United States and all other states." *Id.* *Kraft* involved an Iowa tax that facially discriminated against foreign commerce: "It is indisputable that the Iowa statute treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries." *Id.* at 75. Although Iowa adopted the federal definition of "net income," the federal scheme, unlike Iowa's, avoided discrimination by allowing a credit for taxes paid to foreign countries. The Court therefore found that the tax violated the Foreign Commerce Clause. *Id.* at 82.

Unlike the tax schemes that the Court found invalid in *Memphis Bank* and *Kraft*, Arizona's adoption of federal adjusted gross income as it pertains to mandatory contributions to retirement plans does not inevitably result in

discrimination against federal employees. Rather, both federal and Arizona income tax law distinguish between contributions paid by employees and contributions that are picked up by employers. As the lower court recognized, federal tax law has consistently treated employee contributions differently from employer contributions. (Pet. App. 3a.)

Because the Arizona decision is consistent with this Court's precedents, the Court should deny review.

2. The Arizona Supreme Court Decision Does Not Conflict with Any Other State or Federal Decision.

Although Petitioners acknowledge that twenty-eight States defer the payment of tax on employee contributions that are picked up by their employer, they do not cite to any state or federal decision that is inconsistent with the Arizona Supreme Court decision here. (Pet. at 7; *see also* Jerome Hellerstein & Walter Hellerstein, *State Taxation* § 22.3.04(3)(b) [3d ed. 2004 Supp. No. 1] [discussing the Arizona Supreme Court's decision here and another state case that applies a similar analysis in its post-*Davis* discussion but not noting any conflicting cases].)[11] Given this Court's decision in *Davis* and the state courts' struggle to find appropriate remedies to respond to *Davis*, *id.* § 22.04(3)(a), the absence of any conflicting decisions on

[11] There is a petition for certiorari pending in *Ward v. South Carolina*, U.S. No. 03-1304, 2004 WL 531026 (March 8, 2004). The petition seeks review of the South Carolina Supreme Court's decision in *Ward v. South Carolina*, 590 S.E.2d 30 (S.C. 2003). The South Carolina Supreme Court held that a South Carolina statute that increased state retirement benefits by seven percent in response to *Davis* did not violate 4 U.S.C. § 111.

the issue presented here indicates that this litigation is unique and that the lower court's decision is correct. This Court therefore does not need to grant review.

CONCLUSION

This Court should deny the Petition for Writ of Certiorari.

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No. 03-1495

IN THE

Supreme Court of the United States

SUSAN MORAN, *et al.*,
Petitioners,

v.

J. ELLIOTT HIBBS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Arizona

REPLY IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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IN THE

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REPLY IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

In its opposition, Arizona makes no effort to minimize the importance or pervasiveness of the federal question presented here. Nor does it deny the fact of the unequal treatment of federal employees or contest our assertion that the challenged discriminatory taxation directly implicates the interests of the United States. Rather, Arizona argues principally that the decision below is correct on the merits.

Whether the decision below is right on the merits is ultimately a decision for this Court to make; suffice it to say the unanimous decisions of Arizona's lower courts, finding the discriminatory taxation unconstitutional, demonstrate that the conclusion below is anything but ineluctable. Moreover, Arizona offers no reason to believe that the United States would agree with the decision below, a decision validating a discriminatory tax scheme that forces the United States to subsidize the employment costs of the State of Arizona, as

well as 28 other states. Review by this Court is necessary to address the constitutionality of this pervasive tax scheme and nothing Arizona offers in its opposition suggests otherwise.

1. Central to its argument on the merits—indeed the crux of how Arizona frames the issue before the Court—is the fact that the Congress has excluded from *federal* adjusted gross income the amount of mandatory employee retirement contributions "pick[ed] up" by state employers. *See* Op. Cert. at i. Arizona contends that because Congress has authorized it to pay the mandatory employee contributions for its employees and because Congress has excluded these payments from federal adjusted gross income, its discriminatory taxation of the identical component of federal employees' compensation passes constitutional muster.

Arizona's reliance on the Internal Revenue Code to sanction its discriminatory taxation is misplaced. As this Court made clear in the context of the Commerce Clause, "[t]he adoption of the federal system in whole or in part, [. . .] cannot shield a state tax statute from Commerce Clause scrutiny." *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71, 82 (1992). Arizona offers no reason to suspect that this admonition applies to the Commerce Clause, but not to the Supremacy Clause, and indeed there is none.

Arizona contends that it is merely following federal law. But federal law does not *require* Arizona to exempt mandatory employee contributions from state income tax. Arizona, in the exercise of its sovereign power, has *chosen* to grant this exemption to state and government employees only. Many states that similarly have adopted the federal definition of adjusted gross income have nonetheless chosen to equalize the treatment by imposing state income tax on these contributions even though they are excluded from federal gross income. *See e.g*, Kan. Stat. Ann. § 79-32, 117(b)(vi) (2003); Me. Rev. Stat. Ann. tit. 36, § 5122(G) (West 2003); Md. Code Ann., Tax-Gen § 10-204(f)(1)-(2) (2003); Mass. Gen.

Laws Ann. ch. 32, § 22(10), ch. 62, § 2(a)(1)(1) (2004); N.Y. Tax Law § 612(b)(26) (Consol. 2004).

The Internal Revenue Code simply provides no cover for Arizona's discriminatory taxation. The favored treatment is the direct result of discriminatory legislative action by the State of Arizona. *See Pennsylvania v. Curtis Pub. Co.*, 69 A.2d 410, 422 (Pa. 1949) ("The legal effect of this State's basing its computation of tax on the net income returned to and ascertained by, the federal government is exactly the same as if the Commonwealth had prescribed the same tax base without any reference whatsoever to the 'federal returns'."). Indeed, it is now generally understood that,

> [i]n conforming their tax schemes to the federal model, states incorporate federal tax rules that may not . . . recognize the constitutional restraints on state taxing power. . . . Mechanical application of federal rules . . . at the state level produces results that [may be] . . . unconstitutional.

James C. Smith & Walter Hellerstein, *State Taxation of Federally Deferred Income*: *The Interstate Dimension*, 44 Tax L. Rev. 349, 399 (1989).

Of course, the decision below also directly conflicts with two published decisions of two different panels of the Arizona Court of Appeals. *Pet. App.* 23a-49a; 108a-144a. Significantly, each of these decisions was based upon the extensive, uncontroverted record for summary judgment established by the petitioners. The records in each case established that the element of compensation representing contributions of the two groups were substantively identical. The records also established that Arizona's scheme discriminated in favor of State and local employees and that there was no provision of Arizona law for any of the years in issue by which federal employees could qualify for equal treatment. In fact, the practical effect of Arizona's scheme is to exempt state and local employees only. *Pet.*

App. 132a. This is confirmed separately in the substantive provisions of Arizona pension statutes, which independently grant this exemption. *Pet. App.* 157a-163a.

Thus, the record below establishes that there is overt discrimination based solely on the source of pay. The favored treatment was expressly limited to state and local employees and there was no Arizona provision for any of the years in issue by which equal treatment would be extended to federal employees. This problem is not, as the court below held, one for Congress to mend. Rather, it is one of Arizona's making. Because Arizona has refused to remedy this discrimination, this Court must.

2. Arizona also argues that the decision below does not conflict with the decisions of any other state. In so doing, however, Arizona has unwittingly identified yet another parallel between this case and *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). When this Court granted certiorari in *Davis*, no other court had held that discriminatory taxation of federal pensions was unconstitutional. Indeed, the lack of prior authority invalidating the tax was the cornerstone of the states' (including Arizona's) failed effort to have *Davis* applied prospectively only. *See Harper v. Virginia Dep't of Taxation* 509 U.S. 89, 93 (1993). The lack of countervailing state court authority was not an impediment to review in *Davis* and likewise it is not an impediment here.

In any event, Arizona is myopic in asserting that there is no opposing state authority. As noted above, several states have cured the discrimination by imposing state income tax on their employees' mandatory contributions to state and local pension plans. Maryland, for example, imposes this tax on state employees. So too, its Court of Appeals has recognized the infirmity of relying on the Internal Revenue Code as a shield for unconstitutional state taxation. Specifically, in *Comptroller of the Treasury, Income Tax Div. v. First United Bank & Trust*, 578 A.2d 192 (Md. 1990), the State argued

that the Maryland tax imposed on a mutual fund's distribution of federal interest was constitutional because it was the direct result of a distinction in the federal income tax. The Court of Appeals rejected as "unsound" the Maryland Attorney General's opinion that the Maryland tax on federal interest was valid because the "discrepancy is the direct result of distinctions drawn by federal law . . . ." *Id.* at 199.

Moreover, the reasoning of the Arizona Supreme Court directly conflicts with a long line of authority. As noted above, over fifty years ago the Supreme Court of Pennsylvania squarely rejected the states' tactic of seeking to hide behind the Internal Revenue Code. In *Pennsylvania v. Curtis Publishing Co.*, 69 A.2d at 414, Pennsylvania defended its discriminatory tax by claiming that its corporate tax was based solely on the federal returns of corporations doing business in Pennsylvania. The Pennsylvania Supreme Court rejected the State's justification because it ignored the fact that the tax in issue emanated from the sovereignty of Pennsylvania. *Id.* ("By adopting this mode of ascertaining the tax to be imposed, Pennsylvania did not delegate to the Federal government any of the State's power to tax. The act of taxing is the act of the Commonwealth.") Thus, Pennsylvania too recognizes that using federal income as a starting point cannot justify the imposition of discriminatory state taxes. Similar results have been reached in a number of states. *See Brown v. Franchise Tax Bd.*, 242 Cal. Rptr. 810 (Cal. Ct. App. 1987); *Andras v. Illinois Dep't. of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987); *Matz v. Dep't of Treasury*, 401 N.W.2d 62 (Mich. Ct. App. 1986); *Borg v. Dep't of Revenue*, 774 P.2d 1099 (Or. 1989); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Capital Preservation Fund, Inc. v. Dep't of Revenue*, 429 N.W.2d 551 (Wis. Ct. App. 1988).

Accordingly, Arizona's contention that there is no conflicting state court authority is misguided. The question presented here, involving discriminatory taxation of manda-

tory employee retirement contributions, is one of first impression that has never been raised in any state courts other than Arizona's. But the basic tenet of the decision below–that a state may blithely rely upon the Internal Revenue Code without regard for potentially unconstitutional consequences–is one that has been rejected by this Court and several state courts. Thus Arizona is wrong in asserting that there is no contrary state court authority; indeed, the conflict between the decision below and the decisions of this Court and numerous state courts is a compelling reason for this Court to grant certiorari.

3. In our petition, we argued that this case is substantively identical to *Davis v. Michigan* with two exceptions: 1) that this case involves the *current* compensation of federal employees, not deferred compensation; and 2) that Arizona's discriminatory tax scheme is even more prevalent (utilized in 29 states) than was the discriminatory pension tax invalidated in Davis. Thus, this case involves "discriminat[ion] against [the United States] or those with whom [it] deals"[1] to an even greater extent than did *Davis* and, as such, even more significantly implicates the interests of the United States. For this reason, petitioners submit that this Court should grant certiorari to ensure that states may not discriminate against the United States, and its employees, in the taxation of mandatory retirement contributions.

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[1] *Memphis Bank & Trust Co v. Garner*, 459 U.S. 392, 397 (1983).

CONCLUSION

For the foregoing reasons, and for those reasons previously set forth in the petition for a writ of certiorari, this Court should grant certiorari to review the decision of the Supreme Court of Arizona.

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